# AN EXPLORATION OF WHETHER USING A GLOBAL EMPLOYMENT COMPANY COULD MITIGATE THE SOUTH AFRICAN TAX RISKS IN RELATION TO INBOUND EXPATRIATES IN MULTINATIONAL COMPANIES

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**Abstract**

The main objective of this research paper was to explore whether a multinational company could use a global employment company to employ its expatriates to mitigate, simplify or limit the tax risk for that foreign company when sending expatriates to South Africa. To investigate this topic, an interpretive research approach was used, a doctrinal research methodology was followed, and inductive reasoning was applied. The documentary data used in this research was publicly available. Firstly, the meaning of the term "expatriate" was explored, together with the types of employment arrangements commonly used to employ this type of employee. The South African tax consequences that an inbound expatriate may create for a multinational company were then analysed. These tax consequences were applied to the common types of employment arrangements to determine what the South African tax impact of these arrangements is likely to be and which entity within a multinational group is likely to be affected. It was investigated whether using a foreign global employment company provides any tax simplification or tax mitigation strategies for the multinational company for expatriates inbound to South Africa. The primary conclusions of this research were that it was found that using a global employment company may only provide a tax benefit in South Africa in very specific circumstances: (i) where the economic employer of the expatriate is the South African entity; (ii) where flexibility is required to easily move the expatriate to other jurisdictions; and (iii) where there are multiple home-host country combinations that the multinational group needs to consider when moving its expatriates. It would appear that using a global employment company as the employment arrangement for an inbound expatriate to South Africa may have a fairly limited application if its purpose is to mitigate tax risks. In effect, a global employment company is likely to provide tax benefits only where it acts as an international labour broker for the multinational company of which it is a part.



**Key words**: taxation; expatriate; inbound expatriate; employment arrangement; global employment company.

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# CHAPTER 1: INTRODUCTION

## 1.1 RESEARCH CONTEXT

Many multinational companies have employees within the group who perform professional services in a country (the host country) other than their home employment country ("expatriate employees"). The shifting of expertise cross-border by multinational companies may create a "plethora of tax and other issues" (PwC, 2014: 5) in the host country, both for the multinational company and for the individual employee. The tax consequences for the multinational company may include corporate income tax, value-added tax ("VAT"), employees' tax, social security taxes, a requirement to contribute toward pension funds, etc. (Manyi: 2016; PwC: 2014).

As a result of increasing "globalisation", the tax consequences that multinational companies face relating to their expatriate employees are likely to become more frequent and increase in complexity. It will become increasingly important for multinationals to ensure that the tax consequences associated with expatriate employees are efficiently and effectively managed. Understanding the various tax consequences in the host country will depend on the specific facts of the assignment, including which countries are involved, whether tax treaties are in place, the substance of the employment relationship, the length of the assignment and the services being performed in the host country (De Koker in De Koker *et al*: 2010; Clegg in De Koker *et al*: 2010; Horak in De Koker *et al*: 2010a; Olivier & Honiball: 2011; PwC: 2014). One of the planning possibilities that multinational companies need to consider is the employment arrangement that should be used when their employees are deployed cross-border. The employment arrangement may influence which tax consequences the multinational company will face in the host country as well as which entity within the multinational group will be liable for these consequences (Deloitte Total Reward and Benefits Limited: 2015; PwC: 2014).

Typically, one or more of the following employment arrangements may be used when relocating employees abroad:

- <u>Home-based employment</u> – where the assignee remains employed by the home country employer but is "loaned" or "assigned" to the host country employer. Generally, employees are paid by the home country employer and will return to the home country at the end of the assignment (Deloitte Total Reward and Benefits Limited: 2015; Mohan: 2016; PwC: 2014).

- Host-based employment – where the assignee suspends or terminates his or her employment with the home country employer and is then employed by the host country employer (Deloitte Total Reward and Benefits Limited: 2015). The employee is paid compensation and any benefits by the host country employer (Deloitte Total Reward and Benefits Limited: 2015; KPMG International Cooperative: 2016).
- Dual employment – where assignees are employed both by the home and the host country employers under separate contracts (PwC: 2014). Each entity pays the employee the compensation and benefits related to the services performed by the employee for that employer (KPMG International Cooperative: 2016; PwC: 2014).
- Global employment company – where an incorporated company (which forms part of the multinational company's organisational structure) is established to employ either all or a portion of the multinational's globally mobile employees and the employment of these employees with the home country employer is terminated (Deloitte Total Reward and Benefits Limited: 2015; PwC: 2014). The global employment company "loans" or "assigns" employees to a host country employer (Deloitte Total Reward and Benefits Limited: 2015). In general, these assignees would be paid all compensation and benefits by the global employment company, which would then reclaim these costs (by way of a re-charge) from the host country employer (PwC: 2014). In addition, a service fee may be charged to the host country employer by the global employment company for the assistance that they provide in managing the expatriate employee (KPMG International Cooperative: 2016; PwC: 2014).

Both Deloitte and PwC indicate that using a global employment company as the employer of globally mobile employees may assist in simplifying or limiting various tax consequences for the multinational company (Deloitte Total Reward and Benefits Limited: 2015; PwC: 2014). For example, it may assist in managing the permanent establishment exposure to corporate income tax (Deloitte Total Reward and Benefits Limited: 2015; PwC: 2014) and it "may reduce the number of legislative combinations which need to be addressed and thus limit governance costs and improve compliance while minimising risk" (Deloitte Total Reward and Benefits Limited, 2015:4).

The following South African tax consequences would need to be considered in detail as they pertain to expatriate employees and also in relation to each employment arrangement.

*(i) Corporate income tax*

The gross income definition in section 1 of the Income Tax Act, 58 of 1962 ("the Act") states that a non-resident person (e.g. a foreign company) is taxable in South Africa on any income from a South African source that is received by or accrues to such person. Where a foreign company earns income due to the services performed by its employees or agents while they are present in South Africa, this income is likely to be from a source in South Africa and the foreign company would then be subject to corporate income tax in South Africa on this income. If there is a Double Taxation Agreement (a "tax treaty") between South Africa and the country where the foreign company is tax resident, however, South Africa will only have the right to tax the business profits of the foreign company (even if these profits are from a South African source) where the foreign company has a permanent establishment in South Africa (OECD: 2014; Olivier & Honiball: 2011). Business profits generally refer to income that the foreign company receives from the supply of goods and services (Olivier & Honiball: 2011). Depending on the activities of the expatriates in South Africa, the foreign employer (or another foreign company that is benefitting from employee's services) may create a permanent establishment in South Africa and hence its business profits from a South African source may become subject to corporate income tax in South Africa (Horak in De Koker *et al*: 2010a; Horak in De Koker *et al*: 2010b; Olivier & Honiball: 2011). A foreign company may, for example, win a project to do an installation in South Africa. Employees are sent to South Africa and due to their activities, may create a permanent establishment for that foreign company in South Africa. Even if the foreign company does not have a permanent establishment in South Africa and has no corporate income tax liability, there may still be a requirement to register and submit a "nil" corporate income tax return (Republic of South Africa: 2017).

*(ii) Value-Added Tax*

There is a possibility that a foreign company sending expatriates to South Africa may have to register for VAT in South Africa in terms of the Value-Added Tax Act, 89 of 1991 ("the VAT Act"), where it is carrying on an "enterprise" in South Africa and its taxable supplies exceed the threshold for VAT registration purposes. An enterprise will occur where a foreign company carries out "…an activity continuously or regularly in, or partly in, South Africa in the course of which goods or services are supplied for consideration…" (PricewaterhouseCoopers Tax Services (Pty) Ltd, 2016c: 1). The definition of services may be broad enough to include instances where employees are made available by a foreign company in South Africa, in return for a fee or other compensation payable to the foreign company. Therefore, the activities of the expatriates in South Africa as well as the consideration paid should be considered to determine whether this may result in the foreign company creating an "enterprise" in South Africa (PricewaterhouseCoopers Tax Services (Pty) Ltd: 2016c).

*(iii) Employees' tax*

According to paragraph 2 of the Fourth Schedule to the Act, employees' tax is required to be deducted by all SA resident employers, or the representative employer of any non-resident employer (i.e. an agent of the non-resident employer which has the authority to pay remuneration) who pays or becomes liable to pay remuneration to any employee. If there is a tax treaty between South Africa and the country where the foreign employer is resident, employees' tax may not be required to be deducted, where the requirements set out in the "dependent personal services" article of the respective tax treaty are met.

*(iv) Other South African tax considerations*

There are other tax consequences that would also need to be considered where there are inbound expatriates. These include, but may not be limited to, reportable arrangements (Republic of South Africa: 2016); transfer pricing on any service fees charged between entities; and the deductibility of any re-charges. Note that, as contributions to the Unemployment Insurance Fund and the Skills Development Levy collected by the South African Revenue Service ("SARS") are not added to the general revenue fund, the impact of these payments has not been included in this thesis. In other words, SARS collects these amounts as an agent for other organisations.

Changes to international tax principles were outlined in the Organisation for Economic Co-operation and Development ("OECD") final reports on the 15 action points to combat base erosion and profit shifting ("BEPS") released on 5 October 2015 (PwC: 2015b) and also in the final Multilateral Instrument published by the OECD on 24 November 2016 (OECD: 2016a; OECD: 2016b). In particular, Action 7 of the BEPS OECD report is designed to significantly reduce the threshold used to determine when a permanent establishment is created and increases the likelihood that individuals travelling cross-border will create a corporate tax footprint in the host country for offshore entities within the multinational group (OECD: 2015; PwC: 2015b). Also, the South African response to these changes in international tax principles needs to be considered (to the extent that this becomes available).

The research question is therefore whether the potential tax benefits of using a global employment company are also applicable where South Africa is the host country.

## 1.2 GOALS OF THE RESEARCH

The main goal of this research is to understand whether using a global employment company to employ expatriates stationed in South Africa will in any way simplify or limit the South African tax consequences for the multinational company.

The sub-goals of this research are as follows:

- to describe the different employment arrangements that multinational companies use when sending their employees cross-border and the different categories of expatriate employees;
- to analyse the South African tax impact that inbound expatriate employees may create for foreign companies within a multinational group in relation to the taxes payable to SARS;
- to understand how the South African tax impact relates to the employment arrangement in place and which entity within the multinational group is likely to be impacted by the South African tax requirements, depending on the employment arrangement; and
- to determine whether using a global employment company as the employer of inbound expatriates into South Africa will in any way simplify or limit the adverse tax consequences for the multinational company in South Africa, compared to the other possible employment arrangements.

## 1.3 METHODS, PROCEDURES AND TECHNIQUES

This thesis adopts an interpretative research approach as the research seeks to describe and understand the effect of employment arrangements (Leedy & Ormrod: 2015). A doctrinal research methodology is applied (McKerchar: 2008). This methodology provides a systematic exposition of the rules governing a particular legal category (in this instance, the legal rules relating to different employment arrangements), analyses the applicable rules, explains areas of difficulty and is based purely on documentary data (McKerchar: 2008). Inductive reasoning is used (Leedy & Ormrod: 2015).

The research is conducted in the form of an extended natural language argument, supported by documentary evidence. The documentary data to be used for the research consists of:

- South African tax legislation (including the South African Income Tax Act, the VAT Act and the Tax Administration Act 28 of 2011);
- relevant Government Gazettes, SARS Interpretation Notes, guidelines and publications;
- the OECD Model Convention on Income and Capital, the OECD reports on the BEPS action points, the Multilateral Instrument and OECD commentaries thereto;
- South Africa's response to changes in international tax principles (e.g. responses by the Davis Tax Committee);
- various tax treaties between South Africa and other countries;
- articles, publications and tax alerts issued by accounting firms and articles by South African law firms; and
- textbooks, articles and other writings by recognised authors.

The validity and reliability of the research and the conclusions is promoted by:

- adhering to the rules of the statutory interpretation as established in terms of statute and common law and adhering to accepted interpretation of international tax principles;
- placing greater evidential weight on legislation, the OECD Model Convention and the writings of acknowledged experts in the field; and
- discussing opposing viewpoints (where applicable) and concluding, based on a preponderance of credible evidence and considering the rigour of the arguments.

## 1.4 ETHICAL CONSIDERATIONS

No ethical considerations arise as all the data used for the research are publicly available. Interviews are not conducted; opinions are considered in their written form. All sources of data are appropriately acknowledged, and full references provided.

## 1.5 OVERVIEW OF THE CHAPTERS

This chapter provides the relevant background to the research topic: An exploration of whether using a global employment company could mitigate the South African tax risks for multinational companies when sending inbound expatriates to South Africa. The goals of the research were then set out, the methodology, procedures and techniques used to conduct the research were outlined and it was demonstrated that no ethical considerations apply to this research as all data sources are publicly available.

The following chapters consider the sub-goals as follows:

- Chapter 2 describes the types of expatriates and employment arrangements that are commonly used by multinational companies when employing expatriates.
- The analysis of the possible tax consequences in South Africa for a multinational company when sending an inbound expatriate to South Africa are outlined in both Chapters 3 and 4. Chapter 3 deals with the possible corporate income tax consequences and Chapter 4 outlines the other tax consequences that may apply, including VAT and employees' tax.
- Chapter 5 applies the potential South African tax impact determined in Chapters 3 and 4 to the possible different employment arrangements and determines which entity within the multinational group is likely to be impacted by the South African tax consequences, depending on the employment arrangement. Based on the outcome of this analysis, this chapter explores whether using a global employment company could in any way reduce, mitigate or simplify any of the tax consequences faced by a foreign company when sending an expatriate to South Africa.
- Chapter 6 provides a conclusion to the thesis, summarising the research findings and identifying opportunities for further research.

# CHAPTER 2: EXPATRIATES AND EMPLOYMENT ARRANGEMENTS

## 2.1 INTRODUCTION

Chapter One described the context and goals of the research, the research method and design. This Chapter outlines a more comprehensive understanding of the various types of expatriate employees and the types of employment arrangement used by multinational companies to employ these individuals. This background context of what is meant by the term "expatriate" and the differing employment arrangements is necessary to understand and later compare the different possible employment arrangements, with the tax exposures identified.

## 2.2 EXPATRIATE EMPLOYEES

The term "expatriate" is not defined in the Income Tax Act. Further, there does not appear to be a universal understanding of this term, as illustrated by the following definitions:

- According to the Oxford dictionary, an "expatriate" is "[a] person who lives outside their native country" (Oxford University Press, 2017b: Online). The term "native" is in turn defined as "[a] person born in a specified place or associated with a place by birth, whether subsequently resident there or not" (Oxford University Press, 2017c: Online).
- Investopedia defines an expatriate as "an individual living in a country other than their country of citizenship, often temporarily and for work reasons." (Investopedia LLC, 2017: Online)
- The Financial Times lexicon defines an expatriate as "[a]n employee who is sent to live abroad for a defined time period" (presumably by their employer). (Financial Times, Unknown: Online)

These definitions are all technically different in that the first definition assumes that the individual's "home country" is the country where the individual was born, the second assumes the "home country" would be the country of the individual's citizenship and the third definition assumes that the "home country" is the country where the individual's original employer is situated. In many cases, the above definitions may all refer to the same country (e.g. a German born individual, who is a German citizen and is employed by a German company, is sent to South Africa for the next three years). The "[m]obility of talent is fluid" (PwC, 2012: 4) and the globalisation of the mobile workforce is resulting in more and more instances where these distinctions may not be easy to determine (PwC: 2012).

The following examples illustrate this point:

(a) An individual is born in South Africa, who emigrates to the United States of America when he or she is 10 years old, renounces his or her South African citizenship and then, when he or she is older, this individual is sent by his or her United States employer to work in South Africa for a period of three years.

(b) An individual born in the United Kingdom has dual citizenship both in South Africa and in the United Kingdom. This individual is currently residing in the United Kingdom, working for a company situated in the United Kingdom and is sent to South Africa for the next twelve months.

(c) An individual born in the United Kingdom has dual citizenship both in South Africa and in the United Kingdom. This individual has resided in South Africa for the last 20 years and is working on a permanent basis for a South African employer.

(d) An individual who was born in South Africa and is a citizen of South Africa travels overseas and works in the United States of America for an employer situated in the United States. This employer then seconds this individual to its subsidiary company in the United Kingdom which in turn sends this individual on business trips to South Africa for one week every month.

Depending on the definition applied, each of the above examples may provide different answers to the question of whether these individuals can be defined as inbound expatriates based in South Africa.

Because this thesis deals with the exposure that employees based in South Africa (inbound) may create for their offshore employer (i.e. non-South African employer), and the next two chapters illustrate that the tax exposure to the employer is determined by the employee's relationship with the employer and the services the employee is performing for the employer (i.e. not the individual's place of birth or citizenship), it is assumed that for the purposes of this thesis that the third definition of an expatriate should apply. Therefore, an expatriate should be defined as an employee sent by his or her employer to live and work in another country and the definition of the expatriate employee's "home country" should be the expatriate's country of original employment (Financial Times: Unknown; Waggoner & Punnett: 2017). If this definition is applied, the answer would be that all individuals in the examples, apart from example (c), would be considered inbound expatriate employees into South Africa.

There may still be some disagreement, however, as to whether example (d) should be considered an expatriate employee or not, as the duration of this individual's stay in South Africa is so short that it calls into question whether this individual could be seen to be "living" in South Africa. This is even more so if the employee visits South Africa less frequently, for example, every six months. Also, this type of travel arrangement is likely to be more informal than a formal secondment. This example demonstrates another type of globally mobile employee, namely the short-term business traveller. These types of employees also create tax exposures for their employer, including corporate income tax and employees' tax exposures (PwC: 2015a), that is, tax exposures are created where an employee works in a jurisdiction that is different to the tax residency of his or her employer.

Therefore, in general, employee movements can be split into two distinct categories: formal secondments ("expatriate employees") and informally mobile employees ("short-term business travellers") (Manyi, 2016). Generally, both categories are collectively referred to as "globally mobile employees".

### 2.2.1 Formal secondments

Formal secondments occur where employees are relocated, and this relocation is governed by a formal contract, either short term (a few months) or long term (a number of years). These individuals are normally referred to as secondees, assignees, or formal expatriates. These employees perform services in a country (the host country) which is other than their home employment country (Manyi: 2016). In general, these types of secondments are easier to monitor and manage by a human resource department or equivalent team within a multinational company. Therefore, exposures relating to this type of globally mobile employee are often easier to identify (Price: 2014; Manyi: 2016).

### 2.2.2 Informally mobile employees

Short-term business travellers are defined by PwC (2015a: 4) as:

> *the collective term for globally mobile employees who make working visits to perform short term professional duties in the host country, whereas the assignment details are not formally contracted. Short-term business visitors include, for example rotators, project workers, individuals with regional and/or global roles.*

These employees do not spend a long period in a “host” country location, but rather visit this location on an *ad hoc* basis for a few days or weeks at a time without a formal assignment and may have multiple functions across various geographic locations (Hasbargen: 2014).

The short-term business traveller is currently an area on which tax authorities are focussing (Price: 2014). This type of short term travel is often overlooked by human resource departments, compared to longer term assignments that are easier to monitor (Price: 2014). Although this type of traveller does not have a formal assignment, they can be considered as informal inbound expatriate employees. Therefore, it is important to understand the exposures that these types of globally mobile employees are creating for their employers (and for themselves in their individual capacity) (Price: 2014; Manyi: 2016).

### 2.2.3 Conclusion: expatriate employees

Both categories of expatriate employees have their “own inherent risks” (Manyi, 2016: Online) and can create tax concerns for a foreign company where employees are sent to South Africa. The distinction between these categories is becoming more difficult to determine, as indicated in PwC’s Talent Mobility report which suggests (PwC, 2012: 27):

> *The line between international assignments and business travel is becoming more blurred as time moves on. This raises the question of whether it still makes sense to separate the management of business travel and global mobility. In some organisations, business travel is managed by business units without oversight from HR, and this represents an increasing compliance risk.*

This thesis considers the tax exposures and employment structures of both formal and informal inbound expatriate employees.

## 2.3 TYPES OF EMPLOYMENT ARRANGEMENTS

Multinationals may use several different methods to employ and deploy their expatriate employees. The different methods may be chosen due to ease of application or to assist in the management of tax, immigration or other exposures or obligations to the multinational company (PwC: 2014). In this regard, PwC (2014: 2) states that: “The employment structure or framework should delineate which entities are benefitting from the employee's services and which entity will be obligated to withhold and deposit the applicable foreign taxes triggered by the employee's presence in that country."

Although multiple methods of employment may exist, the following are some of the typical employment arrangements that multinational companies use in relation to their globally mobile employees.

### 2.3.1 As-is employment

This type of employment arrangement occurs where a home country employment contract remains in place, and no employment relationship (in any form) is set up with an entity within the host country (KPMG International Cooperative: 2016). All compensation and benefits are paid by the home country employer. Examples of where this type of employment arrangement is likely to occur are where the home country employer sends a short-term business traveller to the host country (PwC: 2015a) or where the home country employer is engaged on a project in the host country, but there is no local entity in the host country to act as the employer.

Under this arrangement, the home country employer will generally be considered to be both the employee's common law employer (that is, the legal employer) and the economic employer (that is, the employer that receives the economic benefit of the employee).

### 2.3.2 Home-based employment

A home-based employment arrangement occurs where the employee retains his or her employment contract with the employer in the home country and retains a connection with this employer. The employee is "seconded" or "loaned" to a host country employer to work for the benefit of this employer. The employee's home country employment contract is not suspended. The relationship between the host country employer and the employee is normally governed by an assignment letter and the relationship between the home country employer and host country employer is governed by an inter-company services agreement (Deloitte Total Reward and Benefits Limited: 2015; PwC: 2014).

In the situation of a home-based employment arrangement, the employee normally remains on the home country employer's payroll, which pays his or her remuneration. Certain benefits, however, may be provided by the host country employer. The home country employer then charges the host country employer the expenses (by way of a re-charge) associated with the services rendered by that employee in the host country for the host country employer (PwC: 2014).

This type of employment arrangement generally occurs where employees are required to return frequently to their home country. Often a position in the home country employer remains open while the employee is on secondment and the expatriate may return to the home country employer at the end of the secondment period (Deloitte Total Reward and Benefits Limited: 2015).

### 2.3.3 Host-based employment

The host-based employment arrangement is very similar to the home-based employment arrangement, except that the employee's employment contract with the home country employer is "suspended" while he or she is on secondment to the host country employer (that is, the employer temporarily becomes the host country employer and the employee works for the benefit of this employer). As in the home-based employment arrangement, the relationship between the host country employer and the employee is normally governed by an assignment letter and the relationship between the home country employer and host country employer is governed by an inter-company service agreement (Deloitte Total Reward and Benefits Limited: 2015; KPMG International Cooperative: 2016). Normally in this arrangement, the employee is paid all compensation and benefits by the host country employer (Deloitte Total Reward and Benefits Limited: 2015). There may be an arrangement which would allow the employee to return to the home country employer at the end of the secondment (PwC: 2014).

### 2.3.4 Local hire or transfer

Local hire or transfer occurs where the employee terminates employment with his or her home country employer and instead is employed directly by the host country employer on a "local" contract (PwC: 2014). The host country employer will pay all compensation and benefits to the employee, who is treated like a domestic employee. There is generally no guarantee that the employee will be re-employed by the home country employer at the end of the assignment. Under this arrangement, the host country employer will be considered both the common law employer and the economic employer of the employee (PwC: 2014).

### 2.3.5 Dual employment

A dual-employment arrangement occurs where employees are employed both by the home and the host country employers simultaneously under separate employment contracts, each of which have different terms and conditions (PwC: 2014). "The employee reports to both entities and has separate responsibilities regarding both entities" (PwC, 2014: 3). Each entity pays the employee the compensation and benefits related to the services performed by the employee for that employer (KPMG International Cooperative: 2016; PwC: 2014). Under this arrangement, both the host country and home country employers will be considered common law employers and economic employers of the employee, simultaneously (PwC: 2014).

### 2.3.6 Global employment companies

The use of global employment companies occurs where an incorporated company (which forms part of the multinational company's organisational structure) is established to employ either all or a portion of the multinational's globally mobile employees and the employment of these employees with the home country employer is terminated. The global employment company becomes the employer of these globally mobile employees and then "loans" or "assigns" these employees to a host country employer, generally to work for the benefit of this host country employer (Deloitte Total Reward and Benefits Limited: 2015; PwC: 2014). In this arrangement, the global employment company would hold the main employment contract with the employee, although the host country employer would be considered the economic employer (PwC: 2014). The appropriate location of a global employment company normally depends on various situations, but it is not generally in the same country as the home or host employer.

These assignees would normally be paid all compensation and benefits by the global employment company, which would then reclaim these costs (by way of a re-charge) from the host country employer. In addition, a service fee may be charged to the host country employer by the global employment company for the assistance that they provide in managing the expatriate employee (PwC: 2014).

## 2.4 ADVANTAGES OF GLOBAL EMPLOYMENT COMPANIES

The reasons for using a global employment company have varied through the years. Deloitte has illustrated these changing business drivers in the following timeline (Deloitte Total Reward and Benefits Limited, 2015:2):


According to this timeline, one of the key drivers of establishing a global employment company since the 1980s has been the management of the exposure that the home country employer may have to corporate income tax in the host country, through the creation of a permanent establishment. This aspect remains one of the key business drivers today (Deloitte Total Reward and Benefits Limited: 2015). This is confirmed by a PwC publication (Managing mobility in a world reshaped by BEPS) (PricewaterhouseCoopers LLP: 2016) that indicated that 47% of participants in its survey noted that the purpose of considering setting up a global employment company is to help manage any permanent establishment exposure (that is, corporate income tax exposure). This publication goes on to state (PricewaterhouseCoopers LLP, 2016: 10):

> *We* [PwC] *believe GECs* [global employment companies] *present an opportunity to consolidate the management and deployment of a highly mobile workforce, and they can help manage PE* [permanent establishment] *risk. However, they are not, in themselves, a solution to manage PE risk.*

Deloitte explains that one of the main benefits of a global employment company is to manage complex mobility programmes within one company in order to minimise the exposure for a multinational group (Deloitte Total Reward and Benefits Limited, 2015: 4):

> *…the greater the number of home-host country combinations, the more administratively burdensome the management of compliance such as immigration, exchange controls, labour*

*laws, tax and social security laws and anti-corruption laws and laws addressing equity based compensation. A GEC* [global employment company] *model may reduce the number of legislative combinations which need to be addressed and thus limit governance costs and improve compliance while minimising risk.*

According to Zovko (2015: 24), the success of a global employment company structure through the decades is probably due to:

> *...the fact that it involves and provides its services to both HR* [human resources] *and Finance corporate functions. From an HR point of view, it simplifies the hiring process, ensures equity among the expatriate population, reduces the number of exceptions, partners with talent management and personnel retention, waives payrolls complexity and releases Compensation & Benefits from dealing with numerous social security systems and insurers. From a Finance point of view, it enhances rebilling processes and permits for the right cost to be addressed to the right cost centre along with clear financial reports. It eases the collection of data for cost control, financial audits and cost containment.*

A global employment company can be especially useful in standardising and providing consistency in terms of pay, benefits, performance evaluations and policies applicable to expatriate employees (PwC: 2014). “This addresses the lack of consistency that tends to occur when several entities in different home countries assign employees to host countries” (Liazos, 2014: 16). It can also assist in centralising the exposure of any non-compliance, especially in relation to tax and legal compliance (Deloitte Total Reward and Benefits Limited: 2015; Zovko: 2015).

A global employment company may not always be the best fit for the business, and its suitability may depend on numerous considerations (Deloitte Total Reward and Benefits Limited: 2015).

## 2.5 CONCLUSION

This chapter has described the different categories of expatriate employee and further goes on to describe the different employment arrangements used by multinational companies when sending their employees to South Africa. This chapter also outlines the perceived advantages of using a global employment company, which include possible tax advantages.

To determine whether these perceived tax advantages of using a global employment company are applicable in the South African context, it is necessary to understand the South African tax impact that an inbound expatriate employee may create for foreign companies within a multinational group. This South African tax impact for the multinational company is investigated further in the following chapters, starting with the possible corporate income tax impact.

# CHAPTER 3: SOUTH AFRICAN TAX AND INBOUND EXPATRIATES: CORPORATE TAX CONSEQUENCES

## 3.1 INTRODUCTION

The previous chapter explored the meaning of an "expatriate" and the types of employment arrangements that may be used to employ them. The goal of this chapter is to analyse the South African tax impact that inbound expatriate employees may create for a foreign company within a multinational group. In particular, this chapter considers the corporate income tax consequences that an inbound expatriate may create for a multinational company in South Africa. To understand this possible exposure, this chapter discusses both South African domestic legislation and the application of tax treaties. The practical application of the legislation and international tax treaties is demonstrated by means of an example involving an inbound expatriate. This chapter then considers the possible impact of a tax treaty in reducing the corporate income tax exposure that may be created by an inbound expatriate. For this purpose, the concept of permanent establishment is analysed in detail. Finally, the latest developments in international tax are discussed, namely: the impact of the BEPS reports, the Multilateral Instrument and the proposed 2017 update to the OECD Model Tax Convention and Commentaries.

## 3.2 DOMESTIC CORPORATE INCOME TAX PRINCIPLES

According to the definition of "gross income" in section 1 of the Act, tax resident persons are taxable in South Africa on their world-wide income that is received by or accrues to them, whereas non-tax resident persons are taxable in South Africa only on income from a South African source that is received by or accrues to them.

The term "source" is not defined in the Act, although numerous South African tax cases have sought to develop principles and tests to determine the source of an amount (De Koker & Williams: 2017a). These cases have developed the legal principles that should be applied to determine whether or not income earned by a non-resident is from a South African source (De Koker & Williams: 2017a).

One of the cases that set a precedent in determining source is *CIR v Lever Brothers & Unilever Ltd*, 14 SATC 1 ("Lever Brothers"). This case clarified that in determining the source of income, two questions need to be considered: "The first problem is to determine what is the source from which it [income] has been received and when that has been determined the second problem is to locate it in order to decide whether it is or is not within the Union [South Africa]" (*CIR v Lever Brothers & Unilever Ltd*, 14 SATC 1, at 8). These principle questions that should be used in determining source can be summarised as: (i) what the originating cause of the income is; and (ii) what the location is of this originating cause (Olivier & Honiball: 2011; De Koker & Williams: 2017a).

In determining the originating cause of income, *CIR v Lever Brothers & Unilever Ltd*, 14 SATC 1, at 8, states: "…the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income and that this originating cause is the work which the taxpayer does to earn them, the *quid pro quo* which he gives in return for which he receives them".

In *Essential Sterolin Products (Pty) Ltd* v CIR, 55 SATC 357 ("Essential Sterolin Products") the meaning of the "originating cause of income" was considered and agreed with the decision in *CIR v Lever Brothers & Unilever Ltd*, 14 SATC 1. This case determined that the originating cause of income should be based on the work the taxpayer did to earn this income, or what the taxpayer gives in return for this income (De Koker and Lewis in De Koker *et al*: 2010). In this case, the taxpayer was performing work outside South Africa and the source of the income was judged, therefore, to be outside South Africa.

In certain cases, the location of the cause of income may be difficult to determine, as the activities that result in this income being received or accruing may be performed in multiple jurisdictions (De Koker & Williams: 2017a). South African courts generally consider that the source of income should be where the dominant source of the income is (De Koker and Lewis in De Koker *et al*: 2010; Olivier & Honiball: 2011). This approach is followed in numerous cases, including *Transvaal Associated Hide and Skin Merchants v Collector of Taxes, Botswana,* 29 SATC 97 and *CIR v Black*, 21 SATC 226.

There are, however, cases that have held that income should be apportioned, based on the time that the services are rendered in each jurisdiction. This is especially where a dominant cause is not apparent, or where the work in the other country is not purely incidental in nature (De Koker and Lewis in De Koker *et al*: 2010; Horak in De Koker *et al*: 2010a; Olivier & Honiball: 2011). Cases that allowed the apportionment of income include *ITC 1104*, 29 SATC 46 and *COT (SR) v Shein*, 22 SATC 12 (De Koker and Lewis in De Koker *et al*: 2010). Nevertheless, (De Koker and Lewis, in De Koker *et al*, 2010: Online) "one should not lose sight of the fact that ascertaining the actual source of a given income is a practical, hard matter of fact where it may be necessary to adopt a common sense approach".

Although the courts in South Africa sanction the apportionment of the source of income, especially in respect of income derived from services performed:

> *...it is doubtful whether the courts will readily resort to the apportionment of a particular amount of income according to the various sources from which it may have been derived. Regard may instead be had to the dominant or main source of such income: the source may therefore lie in the country in which the main activities may have taken place.* (De Koker & Williams, 2017a: Online)

Although the principles used to determine the source of income are established in case law, section 9 of the Act formalises the rules concerning of the source of specific types of income. This includes royalties, interest, dividends, the holding of an appointed public office and services rendered to specified employers that are generally related to the government of South Africa. Section 9 of the Act does not provide any rules relating to services provided in general and this is determined according to case law as discussed above.

The complexity, in terms of the interaction of the sourcing principles set out in section 9 and case law, normally occurs in understanding the interpretation of a "royalty" (Olivier & Honiball: 2011). This is because sections 9(2)(e) and 9(2)(f) of the Act both indicate that a royalty includes an amount received or accrued for "the rendering of or the undertaking to render, any assistance or service in connection with the application or utilisation of such knowledge or information". In practice, it may be "difficult to distinguish between royalty payments and payments made for the acquisition of skills or services" (Olivier & Honiball, 2011: 375). Therefore, it may be difficult to determine whether the source provisions in section 9 of the Act should apply (that is, for royalty payments) or whether case law provides the principles of how to determine source for skills or services payments (Olivier & Honiball: 2011).

This thesis does not deal with the specific source rules in section 9 of the Act but assumes that the services rendered by the inbound expatriates will fall within the general source provisions established in case law and will not be considered to form part of a royalty payment.

### 3.3 DOUBLE TAX AGREEMENTS (TAX TREATIES)

In terms of section 108(1) of the Act:

> *The National Executive* [of SARS] *may enter into an agreement with the government of any other country, whereby arrangements are made with such government with a view to the prevention, mitigation or discontinuance of the levying, under the laws of the Republic and of such other country, of tax in respect of the same income, profits or gains, or tax imposed in respect of the same donation, or to the rendering of reciprocal assistance in the administration of and the collection of taxes under the said law of the Republic and of such other country.*

This agreement is generally a bilateral agreement between two countries, South Africa and another country, and is termed a Double Taxation Agreement (otherwise known as a "tax treaty"). The main purpose of entering into a tax treaty is (De Koker in De Koker *et al*, 2010: Online):

> *...to avoid double taxation of income and capital by modifying the domestic law and thereby limiting the taxes otherwise imposed by the contracting States. In this way it has the effect of restricting the taxing jurisdiction of the two States, with the primary objective of facilitating cross-border trade and foreign investment and the free movement of labour, and to assist the residents of both States in overseas investments or work-related projects.*

Tax treaties try to allocate income to either the country of the person's residence or the country of the source of the income (Olivier & Honiball: 2011). Residency therefore becomes a key question when considering the application of tax treaties. Tax treaties do not generally have rules relating to the source of income and therefore, generally revert to the domestic legislation in this regard (Olivier & Honiball: 2011). Tax treaties, however, may include certain clauses that specifically determine the source of income (Oliver & Honiball: 2011).

South Africa has tax treaties with over 75 countries to date and is in the process of negotiating tax treaties with several other countries (South African Revenue Service: 2017c).

## 3.4 INTERACTION OF DOMESTIC LEGISLATION AND TAX TREATIES

De Koker in De Koker *et al* (2010: Online) states that "…the relationship between tax treaties and domestic law is complex". The following two questions illustrate some of the complexities involved in understanding the relationship between domestic law and tax treaties (De Koker in De Koker *et al*: 2010):

(i) whether a tax treaty may override domestic legislation; and
(ii) whether the tax treaty may actually create a tax liability.

These questions are not interpreted in the same manner in all countries and would need to be understood in each country when interpreting international principles (Olivier & Honiball: 2011).

In terms of the first question, the general principle in the South African context is that where there is a conflict between South African domestic law and the tax treaty, specific legislation will override general legislation (De Koker in De Koker *et al*: 2010). Therefore, the tax treaty should generally prevail. For example, while South Africa's domestic legislation indicates that the withholding tax on dividends paid by a South African company to its foreign shareholders should be at a rate of 20% (section 64E(1) of the Act), the tax treaty between South Africa and the country where the shareholders are tax resident may reduce this rate to 5%. In this case, provided the requirements in the tax treaty are met and the compliance requirements in South African law are adhered to (South African Revenue Service: 2017a), a South African company would be required to withhold dividends tax at the rate of 5% in terms of the tax treaty – that is, the tax treaty limits the tax that South Africa is entitled to.

In terms of the second question, whether the tax treaty may actually create a tax liability, the general principle in South Africa is that a tax treaty does not in itself create a tax liability (De Koker in De Koker *et al*: 2010). Murphy described it as follows (2016: Online): "it is generally accepted that they [tax treaties] do not create tax but allocate existing taxing rights". In other words, a tax treaty is the "lens" through which a person should apply domestic legislation in that it informs how domestic legislation may be limited but cannot, of itself, create law.

For example, a non-resident company, TopCo, holds 50% of the shares as capital assets in Company A, whose market value comprises of:

- 60% South African fixed property; and

- 40% in other offshore assets (not South African assets).

If TopCo decides to sell its shares in Company A, the determination of whether TopCo is subject to tax in South Africa on this sale is resolved as follows:

- Domestic legislation indicates that capital gains tax will only apply where more than 80% of underlying market value of the shares is directly or indirectly related to immovable property situated in South Africa (paragraph 2(2)(a) of the Eighth Schedule to the Act). As the underlying market value of the shares in Company A comprises of South African fixed property to the extent of only 60%, according to domestic legislation, South Africa does not have the right to tax this sale of shares.
- The tax treaty should then be considered. For this example, it is assumed that the tax treaty between the country where TopCo is resident and South Africa indicates that if more than 50% of the underlying market value of the shares sold comprises directly or indirectly of immovable property, South Africa is entitled to tax TopCo on this sale. Therefore, in this case, as the underlying market value of the shares in Company A comprises of 60% South African fixed property, according to the tax treaty South Africa would have the right to tax this amount.
- As the tax treaty cannot create a tax liability, domestic legislation is followed. Even though South Africa may have taxing rights in terms of the tax treaty, it is submitted that South Africa cannot tax this amount as it is not in accordance with domestic law. As Company A only has 60% of its market value in South African immovable property, TopCo will not be subject to capital gains tax on this transaction in South Africa.

This example demonstrates the tax principles that should be used when interpreting tax treaties: that a tax treaty does not create a tax liability, but rather limits the application of domestic legislation. This principle is important when analysing the tax impact that may be created by inbound expatriates.

## 3.5 TAX TREATY MODELS

When tax treaties are negotiated and drafted, States usually negotiate these tax treaties based on particular tax treaty models (De Koker in De Koker *et al*: 2010). According to De Koker in De Koker *et al* (2010: Online), the reason for this is to ensure "…a considerable measure of uniformity in the format and substantive content of tax treaties. The models also serve as a checklist for negotiators and draftspersons, to ensure coverage of all relevant issues."

While standard models may be used in negotiating tax treaties, tax treaties may differ from each other due to the negotiations of the States. Further, model conventions may be updated over time and the conventions that States refer to in negotiations may also differ over time. Therefore, when considering a specific set of facts, it is vitally important to ensure that the tax treaty between the specific jurisdictions involved is examined in detail (Olivier & Honiball: 2011).

Two of the model conventions commonly referred to by States when negotiating tax treaties are the United Nations Model Double Tax Convention between Developed and Developing Countries (the "UN Model Convention") and the Model Convention on Income and Capital published by the Organisation of Economic Cooperation and Development (the "OECD Model Convention"). According to De Koker in De Koker *et al* (2010: Online): "The main difference between the OECD Model and the UN Model is that the latter imposes fewer restrictions on the fiscal jurisdiction of the source country".

## 3.6 SOUTH AFRICA'S RELATIONSHIP WITH THE OECD

The OECD Model Convention has persuasive force in South Africa and most South African tax treaties are based on the OECD Model Convention (Olivier & Honiball: 2011). South Africa's relationship with the OECD has been described by De Koker in De Koker *et al* (2010: Online):

> *Although it is not a member state of the OECD, South Africa has, to a significant extent, adopted the OECD Model Convention as the basis for its international tax treaties and has generally only made minor adjustments to the text. The Commentary to the OECD Model Convention consequently has persuasive force in the interpretation of the double tax agreements concluded by South Africa which are based on this model.*

Further, since the publishing of the work by De Koker in De Koker *et al* (2010), South Africa has signed the Multilateral Instrument published by the OECD (Nyiri: 2017). This may be considered as a further alignment of South Africa with the OECD principles. A discussion of the impact of the Multilateral Instrument is provided later in this chapter.

As South Africa is not a member of the OECD, SARS can choose to depart from OECD principles. Therefore, although the OECD Model Convention has persuasive force, this does not mean that a court decision will always follow the OECD model. An example is the recent case, *ITC 1878*, (2015) 77 SATC 349 ("ITC 1878"), where the interpretation of the OECD Model Convention does not appear to have been strictly applied (Mazansky: 2015; PwC South Africa: 2015).

As the discussion in this thesis focusses on principles, the OECD Model Convention has been used as the basis for this thesis. It has been noted that SARS can disagree with the OECD interpretation. Also, while tax treaties tend to follow the general OECD Model Convention, each tax treaty may have different clauses and nuances, not all of which are included in the OECD Model Convention. Therefore, in a specific case, the actual tax treaties of the countries involved would need to be examined, based on the facts of the specific case.

This thesis focusses on the 2014 OECD Model Convention and Commentary as this is the version of the OECD Model Convention currently in place (OECD: 2014). The OECD is in the process of updating this document and has released the "Draft Contents of the 2017 Update to the OECD Model Tax Convention" (OECD: 2017a). The likely impact of this update has also been considered in this thesis.

## 3.7 CORPORATE INCOME TAX EXPOSURE CREATED BY AN INBOUND EXPATRIATE

Where a multinational company sends an expatriate to South Africa ("inbound expatriate"), the first step is to identify which company(ies) within the multinational group will earn income as a result of the services that the expatriate renders in South Africa. This is generally the economic employer(s), that is, the employer(s) that receive income, *viz.* the economic benefit from the services rendered in South Africa, which normally follows the entity which has supervision and control of the expatriate's activities. This may not necessarily be the same entity as the expatriate's legal employer (PwC: 2014).

Where a South African tax resident company earns income as a result of the services rendered in South Africa by the expatriate, the income earned will be taxed as part of that company's corporate income tax liability. Tax treaty relief should not be applicable in this circumstance as the residence of the company earning the income and the source of the income are both South African.

The complexity for a multinational company in sending expatriates to South Africa occurs where the services that these individuals render in South Africa result in a non-tax resident (foreign) company earning income. In this case, the first step is to determine whether this foreign company earns income from a South African source in terms of South African domestic legislation (the "gross income" definition in section 1 of the Act and case law).

As indicated above, source is not defined in the Act, but the principles of determining source are outlined in tax cases. Applying the *Lever Brothers* and *Essential Sterolin Products* principles, if:

- the cause of this income is the work being performed by the expatriate; and
- these services are being rendered in South Africa by the expatriate,

the source of the income earned by the foreign company would be considered to be South Africa. In this case, domestic legislation indicates that the foreign company would be subject to corporate income tax in South Africa on this income from a South African source at the current corporate income tax rate of 28%, unless a tax treaty provides relief.

Where the services resulting in this income are performed in multiple jurisdictions, the dominant cause of the income earned by the foreign company should be ascertained in determining if the income is considered to be from a South African source.

As indicated above, a tax treaty cannot create taxing rights and therefore, if the foreign company does not earn income from a South African source, South Africa will not have the right to tax the income earned by the foreign company and there will be no corporate income tax impact in South Africa (De Koker in De Koker *et al*: 2010; De Koker & Lewis in De Koker *et al*: 2010; Horak in De Koker *et al*: 2010b).

Once it is established that a foreign company earns income from a South African source, the next step is to determine whether there is a tax treaty in place between South Africa and the country where the foreign company is tax resident.

### 3.7.1 Where a tax treaty does not exist

If there is no tax treaty between South Africa and the jurisdiction where the foreign company is tax resident, South African domestic rules would apply as outlined above, without any relief that a tax treaty could have provided.

### 3.7.2 Where a tax treaty exists (OECD principles)

Reference to the OECD Model Convention and Commentary in this discussion refers to the 2014 OECD Model Convention and Commentary (OECD: 2014), unless specifically stated otherwise.

A tax treaty first seeks to identify which of the two contracting States is considered to be the State where the taxpayer is resident as a person. This is because a person has to be a resident of one of the Contracting States in order to claim the benefits provided in the tax treaty. The right to tax income is generally determined with reference to the country of residence, and the country of residence normally is required to give a tax credit for taxes paid in the other country, the source country (Olivier & Honiball: 2011). In the case of a foreign company earning income due to the activities of inbound expatriates in South Africa, the country where the foreign company is tax resident would be the Resident State, while South Africa would be considered the Source State.

After residency has been determined, the tax treaty seeks to identify the type of income stream that a person is receiving and provides specific rules as to how that specific income stream should be taxed (Olivier & Honiball: 2011). There are 14 income streams mentioned in OECD Model Convention, namely (reference to the relevant article in the OECD Model Convention has been provided) (OECD: 2014):

- income from immovable property (article 6);
- business profits (article 7);
- shipping, inland waterways transport and air transport (article 8);
- dividends (article 10);
- interest (article 11);
- royalties (article 12);
- capital gains (article 13);

- income from employment (article 15);
- directors' fees (article 16);
- entertainers and sportspersons (article 17);
- pensions (article 18);
- government service (article 19);
- students (article 20); and
- other income (article 21).

As noted previously, the general principle in the South African context is that specific provisions will override general provisions (De Koker in De Koker *et al*: 2010). The same principle is applicable when interpreting which tax treaty article applies, in that if there is an article in a tax treaty applicable to specific income stream, this article will apply in precedence to any general article (Olivier & Honiball: 2011). For instance, only if the income earned does not fit into a specified category, will it be considered under the "other income" article in the OECD Model Convention (that is, article 21).

In examining the tax exposure that inbound expatriates can create for multinational companies, the income stream that the foreign company will be earning from the activities of the expatriates must be determined and thus, which article in the tax treaty will apply.

The term "business profits" is not defined in the OECD Model Convention, but generally refers to income that a foreign company receives from the performance of professional services and other activities, including income from any trade or business (Olivier & Honiball: 2011). This income will be taxed under the business profits article (article 7), unless another article is more specific to that income stream, in which case the more specific article will apply in precedence to the business profits article (Olivier & Honiball: 2011). Therefore, income derived by a foreign company from services rendered by an expatriate should generally be determined with reference to article 7 of the OECD Model Convention. The provisions of this article need to be examined to determine South Africa's taxing rights in relation to business profits and whether South African domestic legislation (that would normally tax this income) would apply or would be limited by the treaty.

### 3.7.3 Business profits

The OECD Model Convention article 7(1) indicates (OECD, 2014: 28):

> *Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.*

Therefore, the business profits of a foreign company will only be taxable in South Africa where that foreign company carries on a business in South Africa through a permanent establishment situated in South Africa. It is therefore important to understand the term "permanent establishment" and when it would be created in South Africa.

### 3.7.4 Permanent establishment

Article 5 of the OECD Model Convention defines the term "permanent establishment" and is broken down into the following paragraphs:

- paragraph 1 deals with the general definition of the term;
- paragraph 2 provides examples of activities that may create a permanent establishment;
- paragraph 3 deals specifically with building, construction or installation projects;
- paragraph 4 provides a list of exceptions where a permanent establishment will not be created;
- paragraph 5 considers situations where there is a dependent agent;
- paragraph 6 considers situations where there is an independent agent and indicates that an independent agent relationship will not in itself result in a permanent establishment; and
- paragraph 7 indicates that control of a company will not in itself result in a permanent establishment.

#### *3.7.4.1 General permanent establishment definition*

The definition of a permanent establishment is contained in article 5(1) of the OECD Model Convention, which states (OECD, 2014: 26): "For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on."

Therefore, for a permanent establishment to exist, the following conditions have all to be met (OECD: 2014):

(i) There must be a "place of business" (that is, "a specific geographical spot has to exist, referred to as the 'location' test" (Olivier & Honiball, 2011: 339));
(ii) This place of business must be "fixed" (that is, "there must be a certain degree of permanence at each geographical spot, referred to as the 'duration' test" (Olivier & Honiball, 2011: 339)); and
(iii) The business of the enterprise must be carried on through this fixed place of business.

These concepts are briefly explained below:

*(i) Place of business*

In terms of the Commentary to the OECD Model Convention, a place of business simply requires that the enterprise has "a certain amount of space at its disposal" (OECD, 2014: 95). There is no requirement that this place is owned or rented by the enterprise. Even illegal occupation of premises would be considered sufficient for there to be a location, that is, a place of business. This location, however, needs to be at the disposal of the enterprise. Therefore, the mere presence of the enterprise at a specific location does not mean that the place of business test has been met (OECD: 2014). For example, where a salesman working for a foreign company visits a customer in South Africa to take an order, this would not in itself create a place of business for the foreign company in South Africa (OECD: 2014). If, however, an expatriate employee works in South Africa for a foreign company and is given an office at the premises of the South African group company to work in, this would be sufficient for the foreign company to have a place of business in South Africa (OECD: 2014).

Therefore, when examining the impact that an inbound expatriate may have on a foreign company, it is essential to understand where this expatriate will be working and whether there will be some type of working space at his or her disposal.

*(ii) Fixed*

In terms of the Commentary to the OECD Model Convention (OECD, 2014: 97), "a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature." Although there is no specified period during which an enterprise needs to be present in a country to meet this duration test, it is generally accepted that if an enterprise is in a country for less than six months, it will not be considered to have met this requirement and should not create a permanent establishment (OECD: 2014).

The Commentary goes on to state that there are a number of exceptions where, even if the duration is shorter than six months, there is a possibility that the degree of permanency will be met. Exceptions include, but may not be limited to (OECD: 2014):

- the nature of the business is that the activities are only carried on for a short period of time or are conducted exclusively in that country; and
- the activities of the business are recurrent in nature.

When applying the general six-month rule, it should be considered that the six months refers to the period that the enterprise (e.g. a foreign company) has a presence in a country, not to the period that a specific expatriate employee spends in that country (Olivier & Honiball: 2011). An example of how this period should be calculated is as follows:

TopCo (a foreign company) sends expatriate employees to work in South Africa for the following periods:

- Mary is sent to South Africa for the period 1 March 2017 to 30 June 2017 (four months); and
- Paul is set to South Africa for the period 1 June 2017 to 30 October (five months).

In this case, although neither expatriate employee was in South Africa for more than six months, in total TopCo had employees in South Africa for the period 1 March 2017 to 30 October 2017 (eight months). This time period is longer than the general six-month rule and it is highly likely that a degree of permanency exists. TopCo is therefore likely to have created a permanent establishment in South Africa (assuming the other requirements of a permanent establishment are met).

When considering the tax exposure that inbound expatriates may create for multinational companies in South Africa, the duration test is one of the most important. The time that each expatriate (including business travellers) spends in South Africa needs to be carefully monitored. The duration of all expatriates then needs to be added up to determine whether the foreign company has spent more than six months in South Africa. This is one of the main possible tax exposures for multinational companies, as monitoring all business travel of its employees can be a difficult task, especially where no centralised reporting functions are set up (PwC: 2015a). In addition to this, the nature of the activities being performed in South Africa also needs to be monitored to understand whether one of the exceptions may apply, which could result in the requirements of this test being met, even where the duration is less than six months.

*(iii) Through which the business of the enterprise is carried on*

In terms of the Commentary to the OECD Model Convention (OECD, 2014: 96), "[t]he words 'through which' must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose". Further, the Commentary indicates that this activity does not need to be productive in nature (OECD: 2014). Therefore, this term is very wide and would be likely to apply where an expatriate is rendering services in South Africa for a foreign company as, in this case, the expatriate will be carrying on the business of this foreign company while in South Africa.

*Conclusion: general permanent establishment definition and inbound expatriates*

In summary, considering the general definition of permanent establishment, where a foreign company sends an expatriate(s) to South Africa and:

- the expatriate(s) has a space at his or her disposal to work in South Africa;

- overall, the foreign company has expatriates working in South Africa for a period longer than six months or activities are such that the six-month rule is not necessary to establish a degree of permanency; and
- the expatriate carries on the business of the foreign company while in South Africa;

there is a high possibility that an inbound expatriate(s) may result in the foreign company creating a permanent establishment (that is, a taxable presence) in South Africa in terms of the general permanent establishment definition. In this case, the foreign company would be liable for South African corporate income tax on any South African source income that it earns at a rate of 28%, unless the specific exclusions to creating a permanent establishment apply, as discussed below.

#### *3.7.4.2 Examples of activities that may create a permanent establishment*

Article 5(2) of the OECD Model Convention provides a list of instances or examples that can be regarded as constituting a permanent establishment, for example, a place of management, branch, office, factory, workshop or mine (OECD: 2014). The Commentary to the OECD Model Convention confirms that this list is not to be considered an exhaustive list, but merely illustrative in nature, considering that the listed examples still need to meet the requirements of article 5(1), the general permanent establishment definition (OECD: 2014).

PwC South Africa (2015) confirm that there are not many tax cases in South Africa that have tested international tax concepts and that *ITC 1878*, (2015) 77 SATC 349 is the first judgement dealing with permanent establishments in South African case law in almost 40 years. In this case, the relationship between of articles 5(1) and 5(2) of the South Africa-United States of America tax treaty (Republic of South Africa: 1997) was considered. The facts were as follows:

- The appellants were two companies, both tax resident in the United States of America (USA Company) that won a contract in South Africa to provide services for a local South African airline.
- USA Company was part of a consulting group that provided advisory services to the airline industry and had offices in ten countries around the world.
- The South African contract began in February 2007 and ended in May 2008. A fee was paid for the success of the project in 2009.

- During the period of the contract (February 2007 to May 2008), USA Company sent 17 of its employees to South Africa as and when required. Of these employees, three formed part of the core project team and at least one of them was in South Africa at all times (on a three-week rotational basis).
- During the 2007 calendar year, the USA Company had employees in South Africa for more than 183 days.
- The USA Company was allocated a space at the client's premises where it was provided the exclusive access to the boardroom during business hours only.

The relevant article in question was article 5(2)(k) of the South Africa-United States of America tax treaty (Republic of South Africa: 1997), an article that is not found in the OECD Model Tax Convention (Mazansky: 2015; PwC South Africa: 2015), which states:

> *2. The term "permanent establishment" includes especially:*
>
> *...k) the furnishing of services, including consultancy services, within a Contracting State by an enterprise through employees or other personnel engaged by the enterprise for such purposes, but only if activities of that nature continue (for the same or a connected project) within that State for a period or periods aggregating more than 183 days in any twelve-month period commencing or ending in the taxable year concerned.* (Republic of South Africa, 1997: 6)

The appellant of the case contended that even if the requirements of article 5(2)(k) had been met (which it contended it hadn't), the requirements of article 5(1) would also need to be met for a permanent establishment to occur. The respondent contended, however, that once the requirements of article 5(2)(k) had been met, that a permanent establishment had automatically been created and there was no reason to consider article 5(1). In other words, the question before the court was whether the term "includes" in article 5(2) indicates an illustration (as in the Commentary to the OECD Model Convention) or an extension of article 5(1) (PwC South Africa: 2015).

The tax court considered the interpretation of articles 5(1) and 5(2)(k) and stated that in following precedents of prior cases, tax treaty interpretation "must give effect to the purpose of the treaty in a manner that is congruent with the words used" (ITC 1878 at page 535 of 77 SATC 349). The judgement went on to state that word "include", as used in law, indicates an extension or enlargement of a meaning and that it was clearly the intention of the drafters of the South Africa-United States of America tax treaty that the definition of permanent establishment in article 5(1) is extended in article 5(2)(k). Therefore, where the taxpayer met the requirements of article 5(2)(k), it created a permanent establishment in South Africa. The court indicated that there was no need to consider whether the requirements of article 5(1) had been met, although it later concluded in an alternative finding that these provisions had been met (Mazansky: 2015; PwC South Africa: 2015).

Mazansky's article (2015: 496) concerning this case concludes as follows: "While the decision might be construed as controversial in that it contradicts the OECD Commentary, it is nevertheless in accordance with judicial precedent. And it must be remembered that South Africa is not a member of the OECD – it only has observer status…".

Although this tax case focused on the application of the South Africa-United States of America tax treaty (Republic of South Africa: 1997), of relevance to this thesis is the interpretation by the tax court of article 5(2) of the tax treaty. According to the OECD Model Convention, the provisions and inclusions in this article are merely illustrative in nature. The outcome of this case appears to suggest that South Africa will interpret article 5(2) differently to the Commentary to the OECD Model Convention in that the terms listed will be treated as an extension of the general permanent establishment definition contained in article 5(1), rather than as illustrative in nature. This is even though ITC 1878 specifically recognised the importance of the OECD Model Convention in interpreting and understanding articles in tax treaties. However, this case accepted that the OECD Model Convention is a useful guideline, but that it should not be adopted *verbatim*.

#### *3.7.4.3 Specific inclusions in the "permanent establishment" definition*

Article 5(3) of the OECD Model Convention includes specific instances where a permanent establishment will be created, even if the general permanent establishment definition in article 5(1) is not met (OECD: 2014). This article is specific to building, construction or installation projects and indicates that a permanent establishment would be created where the project continues for more than 12 months (OECD: 2014). In the UN Model Convention and in a number of South African tax treaties, this period may be reduced, for example, to six months (Olivier & Honiball: 2011). According to the Commentary to the OECD Model Convention, this duration test should be applied to each individual building site or project (OECD: 2014). This means that where a building site or project continues for longer than the stipulated duration, even where a project is split into multiple contracts, there could be a possibility of a permanent establishment being created (Horak in De Koker *et al*: 2010a).

The wording of this specific inclusion article does not indicate that employees are required to be present in South Africa for any length of time (OECD: 2014). The only qualification for a permanent establishment to exist, in this instance, is the duration of the project or building site, that is, where the project lasts for more than 12 months in terms of the OECD Model Convention (OECD: 2014).

#### *3.7.4.4 Specific exclusions from the definition of a "permanent establishment"*

Article 5(4) of the OECD Model Convention lists a number of activities that do not indicate the presence of a permanent establishment, namely (OECD, 2014: 27):

*a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;*
*b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;*
*c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;*
*d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;*
*e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;*
*f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.*

It is therefore essential to determine, where there is an inbound expatriate, whether the activities that are being performed in South Africa by the expatriate may fall within one of the above exemptions.

It has been proposed that the above list of exemptions should be tightened in the 2017 revision of the OECD Model Convention and Commentary in line with BEPS recommendations (OECD: 2015; OECD: 2017a). This has been discussed further below, under BEPS action points and the newly released 2017 draft OECD Model Convention and Commentary update.

#### *3.7.4.5 Dependent agent*

Article 5(5) of the OECD Model Convention deals with the instance where there is a dependent agent who acts (OECD, 2014: 27):

> *…on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise…*

This applies unless the person's activities are "limited to certain specific exclusions, such as the purchase of goods or merchandise for the enterprise" (Pinch and Smit, 2016: Online).

Creating a permanent establishment through the activities of a dependent agent does not require the expatriate to be in South Africa for any period, or to have a fixed place of business (OECD: 2014). Furthermore, it is not a requirement that an employer-employee relationship exists between the enterprise and the agent (Olivier & Honiball: 2011). Rather, this paragraph focusses on the authority given to a person to conclude contracts on behalf of an enterprise and whether this authority is habitually exercised.

When examining the impact that an inbound expatriate may have on a foreign company, it is essential to understand what activities this expatriate will be performing in South Africa and what authority this expatriate will have while in South Africa. For example, it should be considered whether this expatriate has the authority to bind an offshore company to a contract and habitually exercises this right while in South Africa (OECD: 2014). When considering which expatriates are likely to create a dependent agent permanent establishment exposure for an offshore company when visiting South Africa, the role that the expatriate has in the company is likely to provide an indicator of the ability of that expatriate to bind the offshore company in a contract. For example, expatriates with management and directorship roles, especially in the area of sales or legal services, by the nature of their role, may have authority to bind the company they work for.

The question of whether this dependent agent article sufficiently covers situations where there is a dependent agent acting on behalf of a company in a jurisdiction different to the jurisdiction of the company, has been raised in discussions relating to BEPS (OECD: 2015). It has been recommended that this particular article should be widened to include additional activities relating to negotiation of contracts (OECD: 2015; OECD: 2017a) and the 2017 revision of the OECD Model Convention and Commentary reflects this recommendation. The changes to this article and its impact are discussed below, under paragraphs on BEPS action points and the newly released 2017 draft OECD Model Convention and Commentary update.

#### *3.7.4.6 Independent agent*

Article 5(6) of the OECD Model Convention indicates that, provided the independent agent (a "broker, general commission agent or any other agent of an independent status") is "acting in the ordinary course of their business", a permanent establishment should not be created merely because business is carried on in that State through that independent agent (OECD, 2014: 27).

#### *3.7.4.7 Conclusion: permanent establishment definition and inbound expatriates*

As is clear from an examination of the provisions of article 5 of the OECD Model Convention, that there are many ways that an inbound expatriate may create a permanent establishment for a foreign company while working in South Africa.

To determine whether a permanent establishment is created, careful note would need to be taken of the specific facts and circumstances relating to that expatriate and the overall business that the foreign company is performing in South Africa. This includes which entity the expatriate is benefitting by working in South Africa, the period which the foreign company has expatriates in South Africa, the type of work the expatriate is performing in South Africa, whether the expatriate has a fixed place of business, the authority this expatriate has to conclude a contract and bind an offshore company to this contract, *et cetera*.

## 3.8 BEPS ACTION POINT 7 AND SOUTH AFRICA'S RESPONSE

In October 2015, the OECD released the final reports on the 15 action points to combat BEPS. Action 7 dealt with "Preventing the Artificial Avoidance of Permanent Establishment Status" (OECD: 2015). According to this report, tax treaties provide that a foreign enterprise's business profits are only taxable in a State where that enterprise has a permanent establishment in that State (OECD: 2015). The business profits reportable by that permanent establishment in the source State are determined according to profit attribution rules. The first question in determining the taxability of a non-resident company in a source State (in this case, South Africa) is whether a permanent establishment has been created. This report found that certain taxpayers avoided creating a permanent establishment using various strategies, for example (OECD: 2015):

- Where a *commissionaire* arrangement was entered into. This is loosely defined as (OECD, 2015: 9) "an arrangement through which a person sells products in a State in its own name but on behalf of a foreign enterprise that is the owner of these products". Under this arrangement, a foreign enterprise can sell its products in a State without giving rise to a permanent establishment. The profit that that foreign enterprise earns from the sale of these goods would therefore be outside the tax net of the State where the products are sold. The only income likely to be taxed in that State is a minimal commission that the local seller receives for the services of selling the product.
- Contracts were substantially negotiated within a State but were not formally concluded in that State because they were finalised offshore. In this a case, the permanent establishment test considered only the place where the contract was finally concluded; the State could not tax the income earned from contracts that were substantially negotiated in-country, but where the contract was merely signed offshore (OECD: 2015).
- As there has been a change over the years in how business is conducted, what is considered to be core business activities has changed and the listed exemptions that were previously considered to be purely auxiliary or preparatory in nature are now activities that may be core activities of a business. The specific exemption articles were only meant to apply to activities that (as a whole) are auxiliary or preparatory in nature to the business (OECD: 2015).
- It was found that companies were "splitting-up contracts between closely related enterprises" (OECD, 2015, 11) to avoid creating a permanent establishment. This was especially in relation to construction projects and the application of the specific inclusion article (article 5(3)).

To combat these permanent establishment avoidance strategies, the BEPS Action 7 report proposed (PwC, 2015b: 2):

> ... *a widening of the dependent agent test* [article 5(5) of the OECD Model Convention]*; narrowing of the independent agent exemption* [article 5(6) of the OECD Model Convention]*;*

*and tightening of the specific activity exemptions relating to fixed place of business status (preparatory and auxiliary activities)* [article 5(4) of the OECD Model Convention].

*(i) Dependent agent*

It was proposed that the dependent agent article (article 5(5)) should be expanded to include a consideration of where a contract was negotiated, that is, where a person "habitually plays the principle role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" (OECD, 2015: 16).

*(ii) Independent agent*

It was proposed that the independent agent article (article 5(6)) should be narrowed by indicating that if "a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related", it cannot be considered to be an independent agent (OECD, 2015: 16). The term "closely related" considers whether there is common control between the person acting as an independent contractor and the enterprise that this person acts on behalf of.

*(iii) Specific exclusions from a permanent establishment*

It was proposed that the specific exclusion article (article 5(4)) should be narrowed by indicating that all listed activities would only qualify for exemption where "the overall activity of the fixed place of business, is of a preparatory or auxiliary character" (OECD, 2015: 29).

These changes recommended in the BEPS Action 7 report are brought to realisation by the implementation of the Multilateral Instrument (some of the articles of which deal with a permanent establishment) and through updates to the OECD Model Convention and Commentary, the updated draft having been released in 2017.

Action 7 is likely to have a significant impact on global mobility as the proposed changes contained in Action 7 will result in tax being paid "where the 'essence' or 'value' is created" (Brennan, 2016: Online), which will result in greater scrutiny of the activities of expatriates and business travellers to understand the value that these persons create for a multinational group. The recommended lowering of the permanent establishment threshold through the tightening of the various articles as described above "… means that there may well be a greater number of cases where individuals who travel cross-border will be deemed to create a PE [permanent establishment]" (PwC, 2015b: 2).

Beyond the BEPS report itself, it has been noted that some tax authorities have become more active in querying permanent establishment status and are already applying the OECD interpretation of this concept, even prior to the law actually changing (Mullen: 2016).

*South Africa's response*

South Africa's response to Action 7 is that "[i]t will be to South Africa's benefit to incorporate the changes to the definition of a PE [permanent establishment] into all of its tax treaties" (Deloitte Touche Tohmatsu Limited, 2017: 3). Therefore, where tax treaties are negotiated in future, recommendations to combat the fragmentation of activities to artificially avoid a permanent establishment and the possibility of artificially avoiding a permanent establishment through utilisation of the specific exemptions, will be taken into consideration (EYGM Limited: 2017).

## 3.9 MULTILATERAL INSTRUMENT AND SOUTH AFRICA'S RESPONSE

In future, it will not only be bilateral tax treaties that will contain the provisions determining whether a permanent establishment exists, but these tax treaties will have to be read with the Multilateral Instrument. This will involve understanding each jurisdiction's uptake of the Multilateral Instrument, that is, whether they are signatories of this treaty and what position they have taken as to the specific articles that apply in that jurisdiction (OECD: 2016a; OECD: 2016b).

*Multilateral Instrument*

BEPS Action 15 determined that it was both desirable and feasible for a Multilateral Instrument to be developed to enable jurisdictions to implement the recommended changes in the BEPS reports and to amend multiple bilateral tax treaties (Deloitte & Touche: 2015). This Multilateral Instrument has since been developed, and the final version was released on 24 November 2016 (PricewaterhouseCoopers Tax Services (Pty) Ltd: 2016a). This Multilateral Instrument seeks to amend four specific areas identified in the BEPS reports, namely: hybrid mismatches, treaty abuse, avoiding permanent establishment status and dispute resolution (PricewaterhouseCoopers Tax Services (Pty) Ltd: 2016a). This will result in over 2 000 bilateral international tax treaties being updated at the same time, obviating the need to individually re-negotiate all these tax treaties (PricewaterhouseCoopers Tax Services (Pty) Ltd: 2016a; Nyiri: 2017).

In relation to the present thesis, it is relevant to consider Part IV of the Multilateral Instrument (that is, articles 12 to 15), which relates to the avoidance of permanent establishments (OECD: 2016b):

- article 12 deals with the "Artificial Avoidance of Permanent Establishment Status through *Commissionaire* Arrangements and Similar Strategies" (OECD, 2016b: 19);
- article 13 deals with the "Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions" (OECD, 2016b: 20);
- article 14 deals with the "Splitting-up of Contracts" (OECD, 2016b: 22); and
- article 15 refers to the "Definition of a Person Closely Related to an Enterprise" (OECD, 2016b: 23).

This Multilateral Instrument has been drafted in a manner that allows for flexibility in its application for the various Parties to this agreement, which are jurisdictions that have signed the Multilateral Instrument. This flexibility has been created in numerous ways, including (OECD: 2016a):

- allowing the various Parties to the Multilateral Instrument to specify the bilateral tax treaties that this agreement will apply to (termed "Covered Tax Agreements");
- having a minimum standard of provisions that can only be opted out of only in the limited circumstances where similar wording is already contained in a bilateral tax treaty;
- providing an option to opt out of provisions (or parts thereof) in respect of all tax treaties; this reservation option provides that a Party may choose that none of the Covered Tax Agreements will be subject to that provision, irrespective of the choice of the other Parties to the Multilateral Instrument; and
- allowing the various Parties to choose which optional provisions and alternative provisions to apply.

When interpreting the Multilateral Instrument, it is important to note that a specific article or option in an article will only be applicable in the situation where both jurisdictions in a Covered Tax Agreement choose to apply that provision in the Multilateral Instrument (OECD: 2016a). Therefore, if only one country chooses to apply that article and the other country chooses not to, indicating a reservation to opt out of that article or option, that provision in the Multilateral Instrument will not apply (OECD: 2016a). Therefore, while the reservation options are intended to allow for flexibility, "it will also end up resulting in a complex web of permutations" (PricewaterhouseCoopers Tax Services (Pty) Ltd, 2016a: 2).

Therefore, each country that signs the Multilateral Instrument needs to clearly indicate which reservations to the Multilateral Instrument it accepts and to which bilateral tax treaties this choice will apply (OECD: 2016a; OECD: 2016b).

*South Africa's response*

South Africa is a signatory of this Multilateral Instrument (Nyiri: 2017). The alterations to the South African tax treaties will "probably enter into effect in early 2018" (Nyiri, 2017: Online). National Treasury has provided feedback as to how South Africa will interpret the Multilateral Instrument, that is, it has published the list of reservations and notifications that indicates the clauses in the Multilateral Instrument that will apply in the South African context (Nyiri: 2017; National Treasury: 2017). This document also indicates which of South Africa's tax treaties will be subject to which articles of the Multilateral Instrument, that is, which tax treaties will be considered "Covered Tax Agreements" from a South African perspective (National Treasury: 2017).

In relation to the present thesis, National Treasury's response in relation to Part IV of the Multilateral Instrument is relevant (articles 12 to article 15), which outlines what will be applicable in the South African context. National Treasury's decision is reflected in the following table (National Treasury: 2017):

| **Multilateral Instrument** | **Description of article** | **South Africa's position** |
| --- | --- | --- |
| Article 12 | Artificial Avoidance of Permanent Establishment Status through *Commissionaire* Arrangements and Similar Strategies | South Africa has reserved the right for the entire article 12 not to apply to its Covered Tax Agreements. |

| | | |
|---|---|---|
| Article 13 | Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions | South Africa chooses to apply Option A (article 13(2) of the Multilateral Agreement) and has listed 76 tax treaties as Covered Tax Agreements. |
| Article 14 | Splitting-up of Contracts | South Africa has reserved the right for the entire article 14 not to apply to its Covered Tax Agreements. |
| Article 15 | Definition of a Person Closely Related to an Enterprise | [Not applicable] |

This means that the only update to the permanent establishment provision that South Africa has chosen to apply to its Covered Tax Agreements is the update to the specific activity exclusion article (article 5(4) of the OECD Model Convention). In this regard, South Africa has chosen to apply Option A contained in article 13(2) of the Multilateral Instrument that generally indicates that the specific exclusion to permanent establishment only applies where "the overall activity of the fixed place of business, is of a preparatory or auxiliary character" (OECD, 2016b: 20). In terms of article 13(4), the overall business of closely related enterprises needs to be considered to ascertain whether the activities, as a whole, are really preparatory or auxiliary in nature.

Therefore, in considering the impact of the Multilateral Instrument to inbound expatriates in the South African context, the only portion of the permanent establishment definition that has been updated by application of the Multilateral Instrument, out of all the recommendations contained in the BEPS Action 7 report, is the specific exclusions to permanent establishment (article 5(4) of the OECD Model Convention). In future, therefore, the specific exemption will only be possible where the specific listed activities are performed in South Africa and if, overall, these are preparatory or auxiliary in nature and where the other Party to the Covered Tax Agreement has also chosen to apply article 13(2) of the Multilateral Instrument.

## 3.10 UPDATES TO THE OECD MODEL TAX CONVENTION AND COMMENTARY

Currently, the 2014 OECD Model Tax Convention released on 15 July 2014 is the latest version of this Model in circulation and has been utilised to provide the analysis of article 5 (permanent establishment) and article 7 (business profit) in this chapter. The draft contents of the 2017 update to the OECD Model Tax Convention have recently been released (OECD: 2017a) and public comment has been obtained for suggested areas of change that are additional to the BEPS Actions reports (OECD 2017b). The proposed changes to the OECD Model Tax Convention outlined in the draft 2017 update that are relevant to this thesis are as follows (OECD: 2017a):

- The recommended updates to the OECD Model Convention and Commentary contained in the BEPS Action 7 report (as described above) have been included.
- It is confirmed that registration for Value-Added Tax ("VAT") does not in itself create a permanent establishment and is irrelevant in determining whether a permanent establishment exists.

As South Africa tends to follow the OECD model when interpreting the provisions of tax treaties (Olivier & Honiball: 2011), this update to the OECD Model Convention and Commentary is likely to be relevant when understanding the concept of permanent establishment in the future.

## 3.11 CORPORATE INCOME TAX REGISTRATION REQUIREMENTS

When considering corporate income tax consequences in South Africa where there are inbound expatriates, it is not only the corporate income tax liability that should be considered, but also the requirement to register for corporate income tax and submit a tax return. These administration requirements are applied differently from the determination of whether there is a corporate income tax liability. It is possible, therefore, that a foreign company may be required to adhere to administrative requirements, register for corporate income tax and submit a tax return, even when it has no actual corporate income tax liability and has no permanent establishment in South Africa in terms of the relevant tax treaty.

In terms of section 67(1) of the Act: "Every person who at any time becomes liable for any normal tax or who becomes liable to submit any return contemplated in section 66 must apply to the Commissioner to be registered as a taxpayer…" In turn, section 66 of the Act indicates that the Commissioner must give public notice as to which persons need to submit tax returns.

Government Gazette No. 40898, is the public notice that pertains to the 2017 year of assessment. A new public notice is given for each year of assessment. Paragraph 2 of Government Gazette No. 40898 states that (Republic of South Africa, 2017: 2):

> *The following persons must submit an income tax return:*
>
> *...(b) every company, trust or other juristic person, which is not a resident –*
>
> *(i) which carried on a trade through a permanent establishment in the Republic;*
>
> *(ii) which derived income from a source in the Republic; or*
>
> *(iii) which derived any capital gain or capital loss from the disposal of an asset ...*

If the foreign company is found to have a permanent establishment in South Africa, it is clear that it would need to register for corporate income tax and submit the relevant tax returns.

Where a foreign company does not have a permanent establishment in South Africa, but derives income from a South African source, even if this income is exempt or tax treaty relief applies, it still needs to register for corporate income tax in South Africa. Therefore, the only instance where a foreign company, which sends an expatriate to South Africa to work, does not need to register for corporate income tax in South Africa is where it earns no income from a South African source from the activities being conducted by that expatriate employee in South Africa.

Therefore, even if the foreign company does not have a tax liability, sending an expatriate to South Africa may result in tax administration requirements for the foreign company in South Africa.

## 3.12 CONCLUSION

The starting point to determine whether a foreign company has corporate income tax consequences in South Africa is to determine whether this company has any income from a South African source in terms of domestic legislation. Where the dominant cause of income that a foreign company earns is due to the activities of inbound expatriates working in South Africa, this foreign company will be considered to have income from a South African source and will be taxable here, subject to tax treaty relief. Even if tax treaty relief applies, this foreign company will still be required to register for corporate income tax in South Africa and submit returns, even if they are "nil" returns.

Tax treaty relief will be applicable only if there is a tax treaty between South Africa and the country where the foreign company is tax resident and, in terms of this treaty, the foreign company does not have a permanent establishment in South Africa. Determining whether a permanent establishment is created can be fairly complex and the specific facts and circumstances relating to the inbound expatriate and the overall business that the foreign company is performing in South Africa would need to be carefully considered. This includes which entity the expatriate is benefitting by working in South Africa, the period for which the foreign company has expatriates in South Africa, the work the expatriate is performing in South Africa, whether the expatriate has a fixed place of business, the authority this expatriate has to negotiate and bind an offshore company to a contract, *et cetera*.

With the introduction of the Multilateral Instrument and the recent changes to the OECD Model Tax Convention and Commentaries, the threshold of activities that are likely to result in a foreign company creating a permanent establishment in South Africa have been lowered. Also, determining the corporate income tax consequences is likely to become more complex due to the application of the Multilateral Instrument and the provisions of the Instrument each party to this agreement has chosen to implement.

Sending individuals of a multinational company to work in South Africa becomes a complex exercise and it is essential to understand the corporate income tax exposures that the foreign company is likely to be subjected to by virtue of moving persons cross border, and whether there are any employment arrangements that could be used to minimise the possibility of a foreign company creating a permanent establishment in South Africa.

In addition to corporate income tax considerations, the VAT and employees' tax consequences of inbound expatriates also need to be understood. These are dealt with in the following chapter.

# CHAPTER 4: SOUTH AFRICAN TAX AND INBOUND EXPATRIATES: OTHER TAX CONSEQUENCES

## 4.1 INTRODUCTION

The goal of both the previous chapter and this chapter is to analyse the South African tax impact that inbound expatriate employees may create for a foreign company within a multinational group. Whereas the previous chapter specifically discussed the corporate income tax consequences, this chapter recognises that this is not the only income tax exposure that a foreign company needs to be aware of when sending expatriates to South Africa. Other types of taxes that need to be considered include VAT and employees' tax. This chapter specifically analyses the possible South African tax impact of these other tax types where there is an expatriate employee working in South Africa.

## 4.2 VAT CONSEQUENCES

The concept of VAT, as it applies to this situation, is explained as follows:

- the principles of VAT in South Africa;
- the interaction of the VAT legislation with tax treaties; and
- the application of VAT legislation to the situation where foreign companies send expatriates to South Africa.

### 4.2.1 The VAT system in South Africa

VAT in South Africa is an indirect tax which is levied on the use or consumption of goods and services in South Africa (section 7 of the VAT Act). The supply of goods and services in South Africa is subject to VAT at either the standard rate of 14% (section 7(1) of the VAT Act, a zero-rate (0%) (section 11 of the VAT Act), or it may be exempt from VAT altogether (section 12 of the VAT Act).

The basic concept of VAT is that this is a tax imposed on the value that each vendor in a supply chain adds to the product or service (Silver: 2017). VAT comprises of two elements, output tax and input tax: output tax refers to the VAT levied by a vendor in respect of the goods and services supplied by that vendor; and input tax refers to the VAT payable by a vendor on goods or services supplied to that vendor or the importation of goods by that vendor (Silver: 2017). The VAT due by a vendor to SARS is the output VAT charged by the vendor less the input VAT payable by that vendor to the extent to which it is refundable (Silver: 2017).

Output tax is defined in section 1 of the VAT Act as: "in relation to any vendor, means the tax charged under section 7(1)(a) in respect of the supply of goods and services by that vendor…"

The amount of input tax refundable is limited both by the definition of input tax and by section 17 of the VAT Act which outlines the permissible deductions in respect of input tax. Section 1 of the VAT Act, definition of "input tax" indicates that input tax only includes:

> *where the goods or services concerned are acquired by the vendor wholly for the purpose of consumption, use or supply in the course of making taxable supplies or, where the goods or services are acquired by the vendor partly for such purpose, to the extent (as determined in accordance with the provisions of section 17 [of the VAT Act]) that the goods or services concerned are acquired by the vendor for such purpose.*

In the end, the VAT liability on goods or services usually affects the ultimate consumer of the goods or services as this consumer is not generally registered for VAT and therefore cannot claim any offset, deduction or refund of input VAT (Silver: 2017).

The charging provision in the VAT Act is contained in section 7 which states:

> *(1) Subject to the exemptions, exceptions, deductions and adjustments provided for in this Act, there shall be levied and paid for the benefit of the National Revenue Fund a tax, to be known as the value-added tax –*
>
> *(a) on the supply by any vendor of goods or services supplied by him on or after the commencement date in the course or furtherance of any enterprise carried on by him…*

An "enterprise" is defined in section 1 of the VAT Act as:

> *(a) in the case of any vendor, any enterprise or activity which is carried on continuously or regularly by any person in the Republic or partly in the Republic and in the course or*

> *furtherance of which goods or services are supplied to any other person for a consideration, whether or not for profit, including any enterprise or activity carried on in the form of a commercial, financial, industrial, mining, farming, fishing, municipal or professional concern or any other concern of a continuing nature or in the form of an association or club….*

Although the above provisions outline the general requirements of when VAT should be imposed, the requirement to actually charge VAT on a supply and the ability to claim input VAT is only applicable where the taxpayer is registered for VAT, either voluntarily or due to meeting the registration requirements.

*VAT registration requirements*

Section 23 of the VAT Act states which vendors are required to register for VAT. This section indicates that every person who carries on an enterprise with annual taxable supplies exceeding (or who will have taxable supplies exceeding) R1 million needs to register as a VAT vendor. Registration needs to occur in terms of section 23(1) of the VAT Act, either:

- at the end of the month where the vendor's taxable supplies in the course of carrying on an enterprise in the 12 months ending at the end of that month exceeded R1 million; or
- at the beginning of the month where, in terms of contractual obligations, the taxable supplies of the vendor will exceed R1 million in the course of carrying on an enterprise.

A non-resident person who meets these requirements needs to register for VAT, but will be deemed not to have applied for registration until, in terms of section 23(2) of the VAT Act, it has:

- appointed a representative vendor in South Africa; and
- opened a bank account in South Africa for the purposes of carrying on its enterprise.

A "representative vendor" must be a natural person who resides in South Africa and who will be responsible for the duties imposed by the VAT Act. In the case of a non-resident person, this is the agent of the non-resident person who controls that non-resident person's affairs in South Africa or any manager of any enterprise of this non-resident person in South Africa (section 46 of the VAT Act).

The VAT registration threshold of R1 million is reduced to R50,000 where electronic services are provided (section 23(1A) read with section 1, paragraph (b) (vi) of the definition of enterprise in the VAT Act). As this thesis considers the impact of inbound expatriates, it does not consider services that are electronically provided. Further, optional VAT registration may occur where the threshold of taxable supplies amounts to more than R50,000 in a 12 month period (section 23(3) of the VAT Act).

### 4.2.2 VAT and tax treaties

Article 2 of the OECD Model Convention specifically indicates which taxes are included in a tax treaty. This article indicates that a tax treaty covers taxes on income and capital (and similar taxes), but not consumption taxes. Therefore, tax treaties do not provide any protection or relief in respect of VAT being charged. If both the host and home countries of the expatriate employees are liable for VAT or a similar tax, double tax may apply to the same services.

As a separate matter, article 26 of the OECD Model Convention deals with the provisions under which tax authorities can exchange information. This article specifically indicates that the exchange of information is not limited by article 1 (persons covered) or article 2 (taxes covered). Therefore, information may be exchanged relating to the collection of VAT.

### 4.2.3 VAT exposure created by an inbound expatriate

In relation to VAT, the main risk for a foreign company of sending an expatriate to South Africa is that the foreign company may have a VAT liability and a registration requirement in South Africa, adding to its offshore compliance burden. Further, there is a possibility that the consideration received may be subject to VAT both in South Africa and in the foreign jurisdiction.

As indicated above, the following elements must exist for a VAT liability to exist in South Africa (PricewaterhouseCoopers Tax Services (Pty) Ltd: 2016c (read with the VAT Act)):

(i) there must be <u>an enterprise or activity</u> carried on <u>continuously or regularly</u>;
(ii) the activity must be carried on <u>in South Africa</u>;
(iii) this must involve the <u>supply of goods or services</u>;
(iv) there must be <u>a consideration</u> for this supply; and

(v) the vendor must be registered for VAT. This is where the vendor has either met the optional registration threshold of taxable supplies exceeding R50,000 in a 12-month period and has registered for VAT, or the vendor has met the required registration threshold of taxable supplies exceeding R1 million in a 12-month period.

Each of these elements has been explored below as they relate to inbound expatriates sent to South Africa.

*(i) An enterprise or activity carried on continuously or regularly*

The basic premise of an enterprise is that there needs to be an ongoing activity (Silver: 2017). Where a person conducts a once off transaction, this person is not generally seen to be conducting an enterprise or activity (Silver: 2017). The term "activity" is not defined in the VAT Act. The English Oxford Living Dictionaries defines this term as: "[t]he condition in which things are happening or being done" or "[a] thing that a person or group does or has done" (Oxford University Press, 2017a: Online). Hence, this term should be interpreted very broadly.

Where a foreign company sends an expatriate to South Africa, it is necessary to consider whether this foreign company is carrying on an activity in South Africa. Examples of where this could occur include the following:

- where the expatriate employee remains under the control of the foreign company and will act as a representative of the foreign company when working in South Africa or will act as an agent of the foreign company while in South Africa; where this occurs, it can be said that the expatriate will be carrying on activities for the foreign company in South Africa (PricewaterhouseCoopers Tax Services (Pty) Ltd: 2016c; KPMG: 2004); and
- if the expatriate employee is under the control of a South African company, but the foreign company is in the business of making available or providing expatriates to the South African company, the foreign company will be carrying on an activity in South Africa – the activity of providing people (PricewaterhouseCoopers Tax Services (Pty) Ltd: 2016c).

To determine whether the activity is being carried on continuously or regularly, the number of expatriate employees and the duration of their stay in South Africa would need to be considered

(PricewaterhouseCoopers Tax Services (Pty) Ltd: 2016c). Where there are regular secondments to South Africa there is a strong possibility that this requirement will be met. A single secondment for a long period of time, however, may also result in this requirement being met (PricewaterhouseCoopers Tax Services (Pty) Ltd: 2016c).

According to KPMG (2004: Online): "SARS has in the past ruled that certain foreign companies need not register for VAT purposes if the services (i.e. services by its employees) were to be rendered for a limited period only". SARS would need to take account of the specific facts of the case and would need to confirm this through the method of a formal directive (KPMG: 2004).

Where a foreign company regularly sends expatriates to South Africa or where there is a longer secondment, it is likely that this requirement will be met, and the foreign company will be considered as having a continuous activity in South Africa. In cases where the duration of the secondment is not long, and the activity is not regular, it is possible that this requirement is not met (KPMG: 2004). To ensure certainty, it is recommended that a directive is applied for from SARS to confirm that registration is not required (KPMG: 2004).

*(ii) In South Africa*

South Africa does not have "specific place of supply rules" (PricewaterhouseCoopers Tax Services (Pty) Ltd, 2016c: 1). Therefore, the facts of each case need to be examined to determine whether the activity being performed is in South Africa. As the expatriates are physically in South Africa rendering services, it is submitted that this requirement will be met (PricewaterhouseCoopers Tax Services (Pty) Ltd: 2016c).

*(iii) Involving the supply of goods or services*

The term "services" is defined in section 1 of the VAT Act as: "anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage…" As this definition is very wide, it will cover a variety of situations. According to PwC, this definition is (PricewaterhouseCoopers Tax Services (Pty) Ltd, 2016c: 2):

> *broad enough to include the secondment or making available employees by a foreign company to a South African company. This would therefore constitute a supply of services by the foreign*

*company to the South African company in the course or furtherance of an activity conducted in South Africa.*

*(iv) There is a consideration for this supply*

The term “consideration” is defined in section 1 of the VAT Act as:

> *In relation to the supply of goods or services to any person, includes any payment made or to be made…, whether in money or otherwise, or any act of forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods or services…*

According to this definition, if a foreign company receives any payment in cash or otherwise for the inbound expatriate, this will constitute compensation. Barter transactions can also result in a consideration being paid. Any fee paid by the South African company to the foreign company relating to the expatriate’s services in South Africa will be consideration for the service. This includes the recovery by the foreign company from a South African company of salaries, benefits or other costs paid to the expatriate employees, which will constitute consideration, whether a mark-up is charged (Masina: 2016; PricewaterhouseCoopers Tax Services (Pty) Ltd: 2016c).

*(v) The vendor must be registered for VAT*

Where taxable supplies made by the foreign company exceed (or will exceed) R1 million in a 12-month period, the foreign company will be required to register for VAT in South Africa and charge VAT on the supply of any goods and services consumed in South Africa. In determining the amount of taxable supplies, the total of the amounts paid for goods or services, including the recovery of costs such as salaries, benefits or other costs, would need to be determined. Where this adds up to an amount exceeding R1 million in 12 months, VAT registration is required; or adds up to an amount exceeding R50,000 in 12 months, VAT registration is optional (Masina: 2016; PricewaterhouseCoopers Tax Services (Pty) Ltd: 2016c; read with section 23 of the VAT Act).

### 4.2.4 VAT exposure conclusion

There is a risk that a foreign company sending an expatriate to South Africa may be required to register and account for VAT in South Africa if it earns a consideration exceeding R1 million in 12 months from either making the expatriate available or from the expatriate's activities in South Africa. This is because the "supply" of an expatriate is likely to be considered an <u>activity</u> carried on <u>continuously or regularly in South Africa</u> involving the supply of services.

Further, there is a possibility that the consideration received may be subject to VAT both in South Africa and in the foreign jurisdiction, as there is no tax treaty relief available.

### 4.3 EMPLOYEES' TAX CONSEQUENCES

The discussion concerning employees' tax consequences has been set out below as follows:

- the domestic tax principles of employees' tax in South Africa are considered;
- this domestic law is then applied to an inbound expatriate;
- the applicability of tax treaties is considered, and the OECD Model Tax Convention is discussed with reference to an inbound expatriate; and
- the importance of the concept of "economic employer" is considered.

#### 4.3.1 Employees' tax system in South Africa: domestic principles

According to paragraph 1 of the Fourth Schedule to the Act, the term "employees' tax" refers to the amount of tax that must be withheld by an employer from the remuneration paid or payable to an employee in terms of paragraph 2 of the Fourth Schedule. Employees' tax is commonly referred to as Pay-As-You-Earn ("PAYE") (De Koker & Williams: 2017c). The general charging provision for employees' tax is contained in paragraph 2 of the Fourth Schedule to the Act, which states:

> *(1) Every-*
>
> *(a) employer who is a resident; or*
>
> *(b) representative employer in the case of any employer who is not a resident,*
>
> *(whether or not registered as an employer under paragraph 15) who pays or becomes liable to pay any amount by way of remuneration to any employee shall, unless the Commissioner has granted authority to the contrary, deduct or withhold from that amount... by way of employees' tax... in respect of the liability for normal tax of that employee... and shall... pay the amount so deducted or withheld to the Commissioner*

> *within seven days after the end of the month during which the amount was deducted or withheld...*

To understand the impact of this charging provision, the definitions of the following terms need to be considered: "employee", "employer", "representative employer" and "remuneration". These definitions are all contained in paragraph 1 of the Fourth Schedule to the Act:

> *'**employee**' means –*
>
> *(a) any person (other than a company) who receives any remuneration or to whom any remuneration accrues...*
>
> *'**employer**' means any person... who pays or is liable to pay to any person any amount by way of remuneration, and any person responsible for the payment of any amount by way of remuneration to any person under the provisions of any law...*
>
> *'**representative employer**' means –*
>
> *(a) in the case of a company, the public officer of that company...; or*
>
> *(d) in the case of any employer who is not resident in the Republic, any agent of such employer having authority to pay remuneration,*
>
> *who resides in the Republic, but nothing in this definition shall be constructed as relieving any person from any liability, responsibility or duty imposed on him or her by this Schedule...*
>
> *'**remuneration**' means any amount of income which is paid or is payable to any person by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument, pension, superannuation allowance, retiring allowance or stipend, whether in cash or otherwise and whether or not in respect of services rendered...*

The definition of remuneration also specifically includes amounts received or accrued from rendering services and fringe benefits (that is, the cash equivalent value of a benefit or advantage received from employment, such as the use of a car, provision of accommodation, or home flights (De Koker & Williams: 2017c)). De Koker and Williams (2017c) indicate that for an amount to be remuneration, it needs to first comply with the definition of "income" in section 1 of the Act. Income is the amount of gross income left after deducting exemptions (the definition of "income" in section 1 of the Act). Applying this principle in the case of a South African tax resident, gross income is determined on a world-wide basis[1] and therefore, the term remuneration may refer to remuneration on a world-wide basis. In the case of a non-resident, however, in terms of the gross income definition in section 1 of the Act, only income from a South African source is subject to tax in South Africa. Hence, for a non-resident, only remuneration from a South African source may be subject to employees' tax in South Africa.

Understanding who the employer is, is essential in determining who has the obligation regarding employees' tax. Where the employer (the person who pays or is liable to pay remuneration) is a South African tax resident, there is no question that this person is liable to withhold employees' tax on behalf of its employees (paragraph 2(1)(a) of the Fourth Schedule to the Act). Where the employer is not tax resident in South Africa, however, employees' tax will only need to be withheld where that non-resident employer has a representative employer in South Africa (paragraph 2(1)(b) of the Fourth Schedule to the Act). In this case, the representative employer has the obligation to withhold employees' tax on behalf of the non-resident employer. This can be recovered from the person on whose behalf this employees' tax was paid (from the non-resident employer in terms of section 160 of the Tax Administration Act 28 of 2011 ("Tax Administration Act")).

Employees' tax withheld by an employer is set off against the individual taxpayer's personal income tax liability due at the end of the year of assessment. Therefore, employees' tax is the pre-payment of personal income tax due by the individual employee by way of an employer acting as a withholding agent (De Koker & Williams: 2017c).

### 4.3.2 Employees' tax exposure created by an inbound expatriate: domestic position

To determine whether there are employees' tax consequences in South Africa where there is an inbound expatriate, it should be considered whether the charging provision in paragraph 2 of the Fourth Schedule to the Act applies. To determine this, the terms "remuneration", "employee", "employer" and "representative employer" should be considered, as they apply in the context of an inbound expatriate.

[1] Gross income definition in section 1 of the Act.

#### *4.3.2.1 Remuneration*

An expatriate, being a non-resident of South Africa, will only be taxed on the total amount received or accrued from a South African source. De Koker and Lewis in De Koker *et al* explain the concept of South African source as it relates to employment income in this way (2010: Online):

> *It is internationally accepted, and currently recognised by SARS, that income from employment should be taxed in the country where the services are actually rendered, irrespective of the place where the contract is entered into or where the remuneration is paid. In this regard, it has been accepted by the courts as settled law that, prima facie, the test of the source of a payment for services rendered is the place where the services are rendered... if a foreign employer sends his employee to the Republic to buy trading goods and the employee is stationed here for that purpose, the salary he receives is from a South African source, the services being rendered in the Republic. It matters not that the employer is abroad or that the employee's salary is not remitted to the Republic.*

To the extent that an expatriate earns any amount in cash or otherwise in respect of the services that he or she physically renders in South Africa, that amount will be considered to be income from a South African source. Certain tax practitioners argue that if services rendered in South Africa are sufficiently incidental to the services rendered in the home country, these services should not be taxed in South Africa, as the dominant source of the income accrued is offshore (Clegg in De Koker *et al*: 2010; De Koker & Lewis in De Koker *et al*: 2010; Olivier & Honiball 2011). This is likely to be a risky argument and Clegg in De Koker *et al* (2010) states that this argument may, pragmatically, be used for periods up to two weeks, but probably not for longer.

It is assumed that the expatriate, being in an employment relationship, will be compensated for the services that he or she renders in South Africa and that the form of payment will meet the definition of "remuneration" (for example, a salary, bonus, commission, fee, etc.).

#### *4.3.2.2 Employee*

An employee is a person (not a company) that receives remuneration or to whom remuneration accrues. An expatriate will therefore be considered to be an employee in terms of the definition in the Fourth Schedule to the Act as he or she is a natural person that receives remuneration.

#### *4.3.2.3 Employer*

To determine which entity within a multinational group of companies has an employees' tax withholding obligation, it is necessary to determine which entity meets the definition of "employer" (according to the Fourth Schedule to the Act), that is, which entity has paid or is liable to pay remuneration to the expatriate employee. The following are examples of how an expatriate may be remunerated for his or her services:

- The expatriate remains on the payroll of the home country company and this entity pays all of the expatriate's remuneration: the home country employer (non-resident foreign company) will be considered to be the employer of the expatriate for the purposes of the Fourth Schedule to the Act.
- The expatriate moves onto the payroll of the host country company (South Africa) and this entity pays all the expatriate's remuneration: the host country company (a South African resident) will be considered to be the employer of the expatriate for the purposes of the Fourth Schedule to the Act.
- Both the home and host country companies pay the expatriate remuneration (even if one of these entities only provides employment (fringe) benefits, such as accommodation or flights): both companies would be considered to be employers of the expatriate for the purposes of the Fourth Schedule to the Act as both entities pay remuneration.
- The home country company pays all the remuneration of the expatriate but charges the host country company an amount. In this case, it is important to distinguish whether:

  (i) the home country company is charging the host country company for services it is providing to the host country company (for example, charging for a specific deliverable or project such as providing training); or
  (ii) the home country company is re-charging the costs of the expatriate to the host country company (such as salaries, etc.).

  In the first instance, the employee is likely to remain under the supervision and control of the home country company. In this case, there is an argument that the host country company is not liable to pay remuneration to the expatriate but is paying the home country company for a service and has no employment relationship with the expatriate. The payment made should not fall within the definition of "remuneration". The employer of the expatriate employee will remain the home country company for the purposes of the Fourth Schedule to the Act.

In the second instance, where there is a re-charge of costs by the home country company, there is an argument that the host country company is effectively bearing the cost of the "remuneration" of the expatriate and the host country company in South Africa is effectively liable to pay remuneration and will be considered to be the employer of the expatriate for the purposes of the Fourth Schedule to the Act.

Determining which of the situations outlined above applies and hence which entity is the employer is a matter of examining the facts of the arrangement. Both the substance of the arrangement and the contractual form of the arrangement would need to be understood. Where the substance and the form of a transaction are not in agreement, court decisions in South Africa have found that the substance of the transaction should take precedence over its form (such as in *C:SARS v NWK Ltd, 73 SATC 55 [2011] 2 All SA 347 (SCA)*) (De Koker & Williams: 2017b; Stiglingh et al: 2017).

*4.3.2.4 Representative employer*

Where the employer is non-resident, employees' tax is only due where there is a representative employer in South Africa. The representative employer is the person that is responsible for the payment of employees' tax (sections 153 to 155 of the Tax Administration Act). A representative employer means either:

- in the case of a company, the public officer of that company; or
- in the case of a non-resident employer, an agent with the authority to pay remuneration.

A foreign company that is an employer that does not have a public officer in South Africa or an agent with authority to pay remuneration in South Africa is not under any obligation to deduct or withhold employees' tax (Clegg & Stretch: 2017; De Koker & Williams: 2017c). These concepts are discussed further below.

### *(i) Public officer*

In terms of section 246 of the Tax Administration Act, every company carrying on business or having an office in South Africa is required to be represented by a public officer who is an individual residing in South Africa. The term "company" is not limited to South African companies, but also includes "any association, corporation or company incorporated under the law of any country other than the Republic…" (definition of "company" in section 1 of the Act). Therefore, foreign companies with a public officer in South Africa will have a representative employer in South Africa who would be required to withhold employees' tax on behalf of the foreign employer in South Africa.

When considering whether a foreign company will have a public officer in South Africa, Clegg and Stretch (2017: Online) note that "[t]he mere existence of an office – for whatever purpose that office is established – will require the appointment of a public officer and hence the existence of a representative taxpayer for purposes of making payments of PAYE".

A foreign company will have an office in South Africa and will be required to have a public officer in South Africa in the following instances:

- where the foreign company needs to register as an external company (branch) in South Africa;
- where the foreign company has a permanent establishment in South Africa; and
- where the foreign company does not have a permanent establishment in South Africa but is still required to register for corporate income tax in South Africa.

Each of these instances have been described in further detail below.

- <u>The foreign company needs to register as an external company (branch) in South Africa</u>

  Section 23 of the Companies Act 71 of 2008 ("Companies Act") indicates that a foreign company is required to register an external company (that is, a branch) in South Africa with the Companies and Intellectual Properties Commission where it is conducting business in South Africa, which will occur if it:

  > *(a) is a party to one or more employment contracts within the Republic; or*

(b) *... is engaging in a course of conduct, or has engaged in a course or pattern of activities within the Republic over a period of at least six months, such as would lead a person to reasonably conclude that the company intended to continually engage in business or non-profit activities within the Republic* (Section 23(2) of the Companies Act).

Section 23(3)(a) of the Companies Act goes on to state that every external company must maintain at least one office in South Africa. Maintaining an office in South Africa will result in the requirements of section 246 of the Tax Administration Act being met, requiring the branch to be represented by a public officer in South Africa. In terms of South African company law, a branch is not seen to be a legal entity separate from its foreign head office but is rather seen as one and the same entity (Olivier & Honiball: 2011). This means that where a foreign company registers a branch ("external company") in South Africa, it is required by law to have both an office in South Africa and a Public Officer. This will result in the foreign company having a representative employer in South Africa and employees' tax will need to be withheld in South Africa on any remuneration that it pays to an employee.

- <u>The foreign company has a permanent establishment in South Africa</u>

Where there is a permanent establishment in South Africa, it is highly likely that the foreign company will also be conducting business in South Africa in terms of section 23 of the Companies Act and will be required to register as an external company in South Africa. This is because:

- As was discussed in chapter three of this thesis, the general definition of a permanent establishment requires activities to be carried out in South Africa for a certain duration of time to be considered "permanent" in nature (normally longer than six months). This coincides with the requirements relating to when an external company needs to be registered in South Africa: conducting activities for at least six months.
- Even where a permanent establishment is created without reference to the duration of activities being conducted in South Africa (for instance where there is a dependent agent in South Africa), the foreign company will be conducting its activities through a person in South Africa. It is, therefore, likely to be party to an employment contract in South Africa.

The foreign company will, in this instance, be required to maintain an office in South Africa and appoint a public officer.

- <u>The foreign company does not have a permanent establishment in South Africa, but is still required to register for corporate income tax in South Africa</u>

  Registration for corporate income tax in South Africa requires a company to complete an IT77C form (application for registration as a taxpayer), which is available on the SARS website (South African Revenue Service: 2017b). This form requires the taxpayer to complete a number of fields, including the registration number of the company and details of the public officer. Practically, therefore, the foreign company must register as an external company and have a public officer in South Africa prior to registering for corporate income tax in South Africa. The foreign company will therefore have a representative employer in South Africa.

*(ii) Agent with the authority to pay remuneration*

Where the foreign company does not have a public officer in South Africa, it still needs to consider whether it could have a representative employer in South Africa in the form of an agent with authority to pay remuneration. The term "agent" is defined in section 1 of the Act as "includes any partnership or company or any other body of persons corporate or unincorporated acting as an agent". This definition includes the term "agent" in the definition and so is not clear what the meaning of an "agent" is. Legally in South Africa, an "agent" is:

> *a person who has authority to act for and on behalf of another (called the principal) in contracting legal relations with third parties; the agent represents the principal and creates, alters or discharges legal obligations of a contractual nature between the latter and third parties.* (Claassen, 2017: Online)

Merely having an agent in South Africa is not sufficient to create a representative employer. This agent needs to have the authority to pay remuneration. Authority to pay remuneration may be in terms of an express or implied agreement (De Koker & Williams: 2017c). A common indicator that there is a contract in place is where a charge is raised by the foreign company on the local company (sometimes indicated as royalties or management fees) whereby the charges for the employee are borne by a South African entity (De Koker & Williams: 2017c).

To the extent that any person in South Africa is acting on behalf of the foreign company and has authority to pay remuneration, this person would be considered the foreign company's representative employer in South Africa and would be liable to withhold employees' tax on any remuneration paid to the expatriate.

#### *4.3.2.5 Employees' tax exposure created by an inbound expatriate: domestic position - conclusion*

Where the employer of the expatriate (that is, the person who pays or is liable to pay remuneration to the expatriate) is a South African resident, this South African employer would have a liability to withhold employee's tax on remuneration that it pays to the expatriate. A foreign employer, however, would only have a liability to withhold employees' tax where it has a representative employer in South Africa (either a public officer or an agent with authority to pay remuneration). Technically, the circumstances where there is no representative employer in South Africa are likely to be limited to the situation where the foreign employer does not create a permanent establishment, is not seen to be carrying on a business and (where the dominant source is not in South Africa) is not earning income from a South African source.

Complexities may arise when trying to determine which entity is the employer of the expatriate, especially where multiple entities pay remuneration or / and charges flow between the South African company and the foreign company. In these circumstances, it is essential to consider both the substance and the form of the employment arrangement entered into to determine its nature. Some indicators of an employment relationship, in substance, may include the following: understanding which entity the expatriate would sue, to which entity the expatriate reports and which entity's policies the expatriate is expected to follow.

Where a foreign employer is required to withhold employees' tax in South Africa, this entity may not only have a registration liability in South Africa, but it is possible that its employees may also be subject to employees' tax in the home country as well as in South Africa, depending on the application of tax treaties. This may result in potential cash flow issues until such time as it is possible to claim a foreign tax credit in the home country for the tax suffered in South Africa.

One of the incentives that employers sometimes offer their expatriate employees is "tax equalisation" whereby the "employee receives the same net salary and pays the same amount of tax as if he had continued to work in the home country and is in no better or worse off position than if he had stayed in his home country" (Abraham, 2016: 2). In other words, the employer agrees to pay the employee's tax liability on behalf of the employee. In this situation, the payment of employee's tax will itself be considered a fringe benefit provided to the employee on which there is tax, which is paid by the employer, which is a fringe benefit on which there is tax, etc. This fringe benefit of paying tax on behalf of employees, is sometimes known as a "gross up" (Abraham: 2016 and South African Revenue Service: 2015). It is generally accepted that a multiple gross up methodology should be used to determine this liability (South African Revenue Service: 2015). This may result in there being a significant tax cost to the assignment for the foreign employer, depending on the employees' tax liability in South Africa.

### 4.3.3 Employees' tax exposure created by an inbound expatriate: tax treaties

Article 2 of the 2014 OECD Model Convention indicates that tax treaties should apply to taxes on income and capital. As employees' tax is effectively the pre-payment of personal income tax, the provisions of a tax treaty are relevant when determining the employees' personal income tax liability. When considering which tax treaty to apply in determining any tax relief available, it is the tax treaty that may provide relief from personal income tax that needs to be examined. This is the tax treaty between the country where the individual employee is tax resident and the country which is the source of the individual's income.

#### *4.3.3.1 Where a tax treaty does not exist*

If there is no tax treaty between South Africa and the jurisdiction where the individual inbound expatriate is tax resident, South African domestic rules would apply as outlined above, without any relief that a tax treaty could have provided. The only relief available, should the remuneration be taxed in both jurisdictions, is tax relief that may be provided for in the jurisdiction where the expatriate is tax resident.

#### *4.3.3.2 Where a tax treaty exists*

Where a tax treaty applies, the country where the individual expatriate is resident will be considered the Resident State and South Africa will be considered the Source State. To determine which article in the tax treaty should be applied in the case of an inbound expatriate, it is necessary to consider the income stream(s) this expatriate is likely to earn. Although specific income streams may apply in specific circumstances (such as directors' fees or pensions), the most common income stream likely to apply to expatriates sent to South Africa by a multinational company is "income from employment" (article 15).

This thesis does not consider the more specific income streams such as directors' fees or pensions but focuses on article 15 and its application. Further, this thesis does not consider independent contractors and assumes that there is an employment relationship in place with the expatriate employee.

##### *4.3.3.2.1 Income from employment*

According to Olivier and Honiball (2011: 414), article 15 of the OECD Model Convention "deals with income from employment, other than director's fees, the income of artists and sportsmen, pensions and income from government service". Article 15 can be broken down into three paragraphs as follows (OECD: 2014):

- paragraph 1 provides that employment income may only be taxed in the Source State (that is, South Africa) where employment relating to this remuneration is exercised in the Source State;
- paragraph 2 indicates that, despite the general rule in paragraph 1, the Source State may not tax employment income where certain listed conditions are met;
- paragraph 3 provides an exception for where employment is exercised aboard a ship or aircraft operated internationally or aboard a boat operated in inland waterways. This paragraph indicates that this employment may only be taxed in the State where the enterprise has its place of effective management. This paragraph is not considered in this thesis.

In the case of an inbound expatriate employee, article 15(1) of the OECD Model Convention indicates that South Africa will have the right to tax "salaries, wages and other similar remuneration" (OECD, 2014: 33) (which includes fringe benefits) where the employee physically renders services in South

Africa. Article 15(2) of the OCED Model Convention states that notwithstanding the general provision in article 15(1), employment income will only be taxable in the Resident State (home country) (and not in South Africa) if all three of the following conditions are met:

> a) *the recipient is present in the other State* [Source State, South Africa] *for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned, and*
> b) *the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State* [Source State, South Africa], *and*
> c) *the remuneration is not borne by a permanent establishment which the employer has in the other State* [Source State, South Africa]. (OECD, 2014: 33)

These conditions are each discussed in further detail below.

*a) 183-day period*

The first condition is that the expatriate must be in South Africa for 183 days or less within a twelve-month period, starting or ending in a fiscal year. The OECD Commentary confirms that a fiscal year refers to the fiscal year of the State where the employment services are rendered, in this case, South Africa. In practice, SARS treats South Africa's fiscal year for individuals as the tax year which runs from 1 March to 28/29 February each year (Clegg in De Koker *et al*: 2010).

When the number of days is counted, this should include all days such as weekends, holidays and part of a day (OECD: 2014). This does not include days spent in transit (where a person does not formally enter South Africa) and sick days where, due to sickness, the individual cannot leave the country (OECD: 2014; Olivier & Honiball: 2011).

*b) Not paid by or on behalf of an employer resident in the Source State*

The second condition is that the employer that pays the remuneration (or on behalf of which remuneration is paid) must not be a resident of South Africa.

The object and purpose of both the second and third conditions is to ensure that the taxation of employment income in the hands of the employee aligns with the jurisdiction in which the deduction of employment expenses by the employer may be claimed (OECD: 2014). Where no deduction of employee expenses may be claimed by the employer in the Source State, this article aims to ensure that the employment income is not taxed in the Source State in the hands of the employee (and *vice versa*).

To determine whether this second condition is met or not, the term "employer" should be understood. The OECD Commentary does not specifically define this term but does indicate that this second condition may be open to abuse in situations where there is "hiring-out of labour" (OECD, 2014: 265). An example of this would be where an expatriate is legally employed by a foreign company, which acts as a labour broker, and this foreign company assigns this expatriate employee to work for a South African entity for less than 183 days in return for a fee. In this case, the expatriate's remuneration may be argued as being re-charged by the foreign company to the South African entity and therefore, any remuneration paid by the foreign company to the expatriate could be seen as paid on behalf of the South African entity.

It may be difficult to determine "whether the services are rendered in an employment relationship (contract <u>of</u> services) or whether services are rendered under a contract for the provision of services (contract <u>for</u> services)" [own emphasis] (Mohan, 2016: Online). Therefore, it can be difficult to determine whether the fee being paid for the expatriate is a re-charge of the expatriate's expenses, or a fee paid for services provided. This distinction is important in determining whether any remuneration was paid on behalf of the employer in the Source State (South Africa). According to Clegg in De Koker *et al* (2010), if the foreign company charges the South African company for the costs of the employee's salary and benefits, the individual could be said to be, in substance, an employee of the South African company and the remuneration paid to the individual by the foreign company would be paid on behalf of a South African company. This would result in this second condition not being met and employment income would be taxable in South Africa.

PwC describes the OECD Commentary's measures to counter avoidance where the legal employer is not the economic employer as follows (PricewaterhouseCoopers Auditing Ltd, 2013: 2-3):

> *...substance should prevail over form, which means that the term employer should be considered in a broader sense and the whole context of the employment should be reviewed to determine which entity is the "economic employer" of the employee under the provisions of the treaty and*

*to be able to decide whether exemption under Article 15 can be granted to avoid host country taxation.*

*For this purpose, the key consideration is which entity bears the responsibility or risk for the results produced by the individual's work. If the risk and responsibility does not lie with the formal employer, additional factors may be relevant to determine which entity will qualify as "economic employer" under the treaty...*

The term "economic employer" can be thought of as the employer when considering the substance of the facts and is not necessarily the same as the legal employer (Makola: 2007).

The other factors listed in the OECD Commentary that may be relevant in determining the nature of the services being performed and which entity is the "economic employer" are as follows (OECD, 2014: 268):

- *who has the authority to instruct the individual regarding the manner in which the work has to be performed;*
- *who controls and has responsibility for the place at which the work is performed;*
- *the remuneration of the individual is directly charged by the formal employer to the enterprise to which the services are provided...;*
- *who puts the tools and materials necessary for the work at the individual's disposal;*
- *who determines the number and qualifications of the individuals performing the work;*
- *who has the right to select the individual who will perform the work and to terminate the contractual arrangements entered into with that individual for that purpose;*
- *who has the right to impose disciplinary sanctions related to the work of that individual;*
- *who determines the holidays and work schedule of that individual.*

In the case of an inbound expatriate, where these factors point to the South African company as being the economic employer, there is a possibility that any costs paid to the home country employer by the South African company will be considered merely a recovery of the expatriate's costs. In this case, any amount paid by the foreign company will be seen to be paid on behalf of a South African employer and this condition will not be met, resulting in the income from employment being taxable in South Africa.

### c) *Not borne by a permanent establishment in the Source State*

The third condition is that the remuneration of the expatriate must not be borne by a permanent establishment of that foreign employer in South Africa. According to the OECD Commentary, the phrase “borne by” should be interpreted in light of the object and purpose of this condition, namely, that this exemption should not be available where the remuneration expense may result in a deduction for income tax purposes in South Africa (OECD: 2014).

The OECD Commentary goes on to state (OECD, 2014: 264):

> *...the proper test is whether any deduction otherwise available with respect to that remuneration should be taken into account in determining the profits attributable to the permanent establishment. That test would be met, for instance, even if no amount were actually deducted as a result of the permanent establishment being exempt from tax in the source country or of the employer simply deciding not to claim a deduction to which he was entitled.*

For the third condition to apply, it should be determined whether an income tax deduction in relation to the remuneration is available to a permanent establishment of that foreign company in South Africa. If so, this third condition will not be met, and income from employment may be taxed in South Africa according to its domestic provisions.

When testing this condition, it is important to understand which tax treaty should apply in so-called triangular cases, where the foreign employer has a permanent establishment in South Africa and the foreign employer is not a resident in either South Africa or the country where the employee is tax resident, but in a third State (Olivier & Honiball: 2011). This case raises the question of how the term “permanent establishment” used in Article 15 should be interpreted. Which tax treaty should be used to define the term, the tax treaty between South Africa and the country where the <u>foreign employer</u> is tax resident or the tax treaty between South Africa and the country where the <u>employee</u> is tax resident? This is an important distinction as tax treaties differ and the determination of what constitutes a permanent establishment may vary depending on the tax treaty used. Olivier and Honiball (2011) indicate that the Danish High Court had to consider this question and indicated that the tax treaty between the Source State and the Resident State of the <u>employee</u> should apply. This is because tax treaties are designed to solve bilateral tax conflicts and not triangular conflicts. Applying this to the case of inbound expatriates, the term “permanent establishment” should be considered in the context of the tax treaty between South Africa and the country of residence of the employee (Olivier & Honiball: 2011).

#### *4.3.3.3 Economic employer and South Africa*

While South Africa is not a member state of the OECD, it does largely adopt the OECD Model Convention, and this is likely to have persuasive authority in court. Therefore, in the case of an inbound expatriate, it is likely that South Africa will follow the route of examining the substance of the economic relationship over the form. The principle of the substance of an arrangement taking precedence over the form of an arrangement is also a well-established principle in South African case law (*C: SARS v NWK Ltd, 73 SATC 55 [2011] 2 All SA 347 (SCA)*). Therefore, this OECD interpretation outlined in the OECD Model Convention is likely to be applied in South African courts.

SARS also released a Binding Private Ruling (BPR 085), which dealt with the interpretation of the articles dealing with dependent personal services (income from employment) in tax treaties between South Africa and each of India, the United States of America, Romania, the Czech Republic, the United Kingdom and the Netherlands (South African Revenue Service: 2010). BPR 085 also dealt with the obligation of the employer to withhold employees' tax in accordance with paragraph 2 of the Fourth Schedule to the Act. Briefly, the facts of this BPR were as follows (South African Revenue Service: 2010):

- A multinational group of companies established a talent pool of individuals that any of its companies world-wide could draw upon to supplement their resources.
- The South African company drew on this talent pool, resulting in inbound expatriates physically coming to South Africa for less than three months at a time.
- These inbound expatriate employees remained full time employees of their respective formal employers in their country of residence (foreign employers).
- They continue to be paid their remuneration by their foreign employers.
- The South African company paid a fee per hour for these expatriate employees, which took into account the salary, overheads and a percentage fee.
- The South African company also paid local fringe benefits for these expatriate employees (e.g. accommodation).

- During the South African project, these expatriate employees report to a South African project manager of the South African company and are under the South African company's supervision and control.
- The South African company will have the right to the work of the expatiates and will bear the relative responsibility and risk for that work.

BPR 085 concluded that (South African Revenue Service: 2010):

- the South African company will be regarded as an "employer" of the expatriate employees for the purposes of applying the dependent services article of the various tax treaties;
- South Africa, in terms of the various tax treaties, will be entitled to tax the remuneration of the expatriates relating to the South African project; and
- the South African company will be required to withhold and pay over employees' tax for these expatriate employees.

It can be seen from the conclusion of this BPR that SARS used the economic employer argument outlined in the OECD Commentary to bring the remuneration paid to these expatriate employees into the South African tax net. The South African company was in substance the employer and therefore the payment of remuneration by the foreign employer was deemed to be paid on behalf of the South African company and employees' tax should have been withheld by the South African company. This indicates that South Africa will follow the "economic employer" argument as indicated in the OECD Commentary when determining the employees' tax liability of an inbound expatriate arrangement.

## 4.4 OTHER SOUTH AFRICAN TAX AND REPORTING CONSIDERATIONS

### 4.4.1 Reportable arrangements

Section 34 of the Tax Administration Act defines an "arrangement" as "any transaction, operation, scheme, agreement or understanding (whether enforceable or not)". Section 35 of the Tax Administration Act indicates instances where an arrangement will be considered a reportable arrangement and provides for the Commissioner to list reportable arrangements in a Public Notice in the Government Gazette. Reportable arrangements are required to be disclosed to SARS. This does not mean that the activities of a reportable arrangement are automatically prohibited, rather disclosure allows SARS to monitor whether this arrangement is being taxed correctly in South Africa and determine whether anti-avoidance measures should be considered to nullify the tax benefits of the arrangement (Clegg & Stretch: 2017).

Public Notice No. 140 (Government Gazette 39650), issued on 3 February 2016, introduced a reportable arrangement relating to services rendered by foreign persons (PricewaterhouseCoopers Tax Services (Pty) Ltd: 2016b; Republic of South Africa: 2016). This reportable arrangement is relevant in certain instances where there are inbound expatriates. Paragraph 2.6 of this Public Notice indicates that a reportable arrangement will occur where all the following conditions are met (Republic of South Africa: 2016):

- services are rendered to a resident, or to a non-resident person that has a permanent establishment in South Africa to which the arrangement relates;
- the services rendered comprise of consultancy, construction, engineering, installation, logistical, managerial, supervisory, technical, or training services;
- for the purposes of rendering these services, a non-resident person, employee, agent or representative of that non-resident person is physically present in South Africa (or is anticipated to be so); and
- the expenditure in relation to the services does not qualify as remuneration for purposes of the Fourth Schedule to the Act and the expenditure to be incurred from 3 February 2016 exceeds (or is anticipated to exceed) R10 million in aggregate (PricewaterhouseCoopers Tax Services (Pty) Ltd: 2016b; Republic of South Africa: 2016).

Where all the conditions are met, the arrangement will be considered reportable and the participant in this arrangement must disclose the arrangement to SARS.

An example of where this would occur is where a foreign company provides training services to a South African company and sends employees to South Africa to render these training services. The foreign company does not create a permanent establishment in South Africa. The remuneration of these expatriate trainers is paid in full by the foreign company and is not re-charged to the South African company in any way. The South African company pays the foreign company an amount for training services. In this instance, the South African company, being a participant in an arrangement, will need to consider whether this is a reportable arrangement.

Applying the facts of this example to the reportable arrangement requirements, training services are being provided to a resident by a non-resident whose employees are expected to be physically present in South Africa. If the fees being paid by the South African company for these training services do not constitute remuneration and exceed or are expected to exceed R10 million, this will be considered a reportable arrangement. The South African company, being a participant in the arrangement would be required to report it to SARS.

### 4.4.2 South African tax consequences of re-charges

Where the company paying the remuneration of the expatriate employee is not the company controlling the employee and receiving the benefit of the employee's services, this can cause a number of tax concerns. In particular, questions about corporate income tax deductibility of the expenses and transfer pricing may need to be considered. This mismatch of expenses compared to the benefit of the employee's services could happen either (i) where the home country company is paying the expatriate, but the host country company is benefitting from the expatriate's services; or (ii) where the host country is paying the expatriate, but the home country employer is the entity benefitting from the expatriate's services. This mismatch may occur even in cases where certain benefits are paid by the host country company (such as accommodation, car or flight costs), but the remaining remuneration is paid by the home country company.

*Corporate income tax deductibility*

In terms of corporate income tax deductibility, the specific legislation applicable to the company paying the remuneration would need to be considered to determine whether this amount may be deducted, where the cost does not benefit the company. In a South African context, income tax deductibility would be an issue if the expense was not incurred for the benefit of the company claiming the deduction. This is because generally the expense would not be able to be deducted where it was not incurred in the production of that company's income (section 11(a) of the Act). This is one reason why the entity paying the remuneration to the expatriate may re-charge the costs of the remuneration to the entity that actually benefits from the employee's services, allowing this entity to claim the deduction of the expenses incurred.

*Transfer pricing*

Where the home and host country companies are connected persons, transfer pricing may be applicable, depending on the tax legislation in the home and host countries. In South Africa, transfer pricing, provided for in section 31 of the Act, dictates that where there are transactions between cross-border connected persons, these transactions should occur on an arm's length basis (as if the transaction was between unconnected, third parties). When re-charging a company for the costs of the expatriate employee, transfer pricing would apply where the home country and the host country companies are connected parties. In this case, any re-charge should be within the benchmark of what would be charged by unconnected, third parties. Where transactions are not at "arm's length" certain adjustments are made to the taxable income of the South African entity.

In South African legislation, two companies would be considered connected persons in the following circumstances (definition of "connected person" in section 1 of the Act):

- Where the companies would be considered part of the same group of companies "if the expression 'at least 70% of the equity shares' was replaced with 'more than 50% of the equity shares or voting rights' in… the definition of 'group of companies' " (paragraph (d) of the definition of "connected person" in section 1 of the Act); or
- Where at least 20 percent of the equity shares or voting rights in the company concerned are held by another company and no other shareholder holds the majority of the voting rights; or
- Where any other company is managed or controlled by (i) any person which is a connected person in relation to such company, or (ii) by a person that is a connected person to the person described in (i).

**4.4.3 Withholding taxes**

Many jurisdictions have specific legislation providing for a withholding tax where fees are paid by a local company to a foreign company for services rendered. South Africa does not have this type of withholding tax. This type of transaction is monitored in South Africa through the reportable arrangement legislation and, if the foreign company is found to have a permanent establishment in South Africa, the foreign company may be subject to South African corporate income tax on this service fee income.

This thesis does not consider the situation where the services provided by inbound expatriates are classified as part of a royalty. Royalties paid by a South African resident to a non-resident are generally taxed at a withholding tax of 15% (subject to the application of tax treaties which may reduce this amount) (section 49B of the Act).

## 4.5 CONCLUSION

A foreign company sending expatriates to South Africa would need to consider a number of tax consequences in South Africa, not only corporate income tax. The foreign company may also be found to be liable for VAT and employees' taxes.

A foreign company would need to register and account for VAT where it carries on an enterprise or activity continuously or regularly in South Africa, which involves the supply of goods or services, and a consideration is paid for this supply amounting to over R1 million (the VAT registration threshold). The term "services" is wide enough to include the provision of the services of expatriate employees. Therefore, the two main questions to determine if a foreign company has a VAT liability or registration requirement when sending inbound expatriates to South Africa are: (1) whether these services are provided continuously or regularly; and (2) whether the fees will exceed the registration threshold of R1 million in a 12-month period.

In terms of domestic legislation, employees' tax must be withheld where an employer pays or is liable to pay remuneration to an employee. Where an expatriate is sent to South Africa, there appear to be only two instances where the employer will not be liable for employees' tax: (1) where the employer is non-resident and does not have a representative employer in South Africa; or (2) where tax treaty relief applies.

A representative employer can include a public officer of a company or any agent with authority to pay remuneration. A public officer is required to be appointed by every company that has an office in South Africa (which is required when a branch is registered, when a permanent establishment is created, and in practice, where the foreign company has income from a South African source).

Tax treaty relief from employment income (article 15 of the OECD Model Convention) will only be possible where all the following conditions are all met:

(1) the employee spends a period(s) not exceeding 183 days in South Africa in a 12-month period (starting or ending in a fiscal year);
(2) the employee's remuneration is paid by or on behalf of an employer who is not resident in South Africa; and
(3) the remuneration is not borne by a permanent establishment of that employer in South Africa.

When interpreting the above conditions, the substance of the arrangement should take precedence over the form. Therefore, if the economic employer of the expatriate (that is, the entity that bears the responsibility or risk for the work the expatriate performs and enjoys the economic benefits) is a South African employer, the second condition above is not likely to be met. This is because even if the legal employer is offshore and the expatriate is paid offshore, this payment will be seen as being paid on behalf of a South African employer.

The possible tax exposures notwithstanding, any South African entity to which the foreign company provides certain services, will need to disclose the foreign company's activities in South Africa by way of a reportable arrangement, if the expenditure on services is not considered to be remuneration and is more than R10 million in aggregate. It is proposed that of this provision will assist SARS in identifying the foreign companies at risk of creating a permanent establishment in South Africa, as well as assessing transfer pricing contraventions and VAT non-compliance (EYGM: 2016).

Ignoring the numerous potential tax consequences of sending expatriates to South Africa is not an option for a foreign company, as this may expose the company to penalties, interest and reputational damage. The foreign company will be required to comply with the tax legislation in South Africa, register and pay the correct amounts, unless the tax consequences can be mitigated.

The following chapter considers the relationship between the tax exposures identified in Chapters 3 and 4 of this thesis and the employment arrangement used when sending individuals of a multinational company to work in South Africa. The chapter also considers whether using a global employment company as the employer of inbound expatriates into South Africa will in any way simplify or limit the adverse tax consequences for the multinational company in South Africa, compared to the other possible employment arrangements.

# CHAPTER 5: APPLICATION OF SOUTH AFRICAN TAX TO EMPLOYMENT ARRANGEMENTS

## 5.1 INTRODUCTION

The previous chapters considered the meaning of an “expatriate”, the types of employment arrangements that may be used for their employment and the tax consequences that may be faced by a multinational group of companies when sending inbound expatriates to South Africa. As discussed previously, sending an expatriate to South Africa may result in the foreign company being subject to the following taxes in South Africa: corporate income tax, VAT and employees’ tax.

The aim of this chapter is to understand how the South African tax impact relates to the employment arrangement in place and which entity within the multinational group is likely to be impacted by the South African tax requirements, depending on the employment arrangement. Based on this analysis, this chapter goes on to explore whether using a global employment company as the employer of inbound expatriates into South Africa could in any way simplify or limit any of the tax consequences faced by a foreign company when sending an expatriate to South Africa, compared to other possible employment arrangements.

## 5.2 SOUTH AFRICAN TAX CONSEQUENCES APPLIED TO THE DIFFERENT EMPLOYMENT ARRANGEMENTS

This section considers the tax consequences outlined in chapters three and four and applies these tax consequences to each of the different employment arrangements discussed in chapter two. While the section below seeks to outline the general tax consequences likely to occur in each employment arrangement, a case-by-case determination of the tax consequences would need to be conducted in practice to determine the actual tax impact of a secondment.

### 5.2.1 As-is employment

In this type of employment arrangement, both the legal employer and the economic employer of the expatriate remains the home country employer. There is no formal agreement with any entity in the host country that governs a visit to the host country (KPMG International Cooperative: 2016). This type of arrangement is likely to be used where the home country employer sends short term business travellers to South Africa, or where it does not have a group entity in South Africa (PwC: 2015a). It is assumed that the home country employer will pay the expatriate's remuneration. The likely tax consequences of this type of arrangement in South Africa are as follows:

#### *5.2.1.1 Corporate income tax consequences*

Where the home country employer earns income (for example, business profits) due to the activities being performed by the expatriate in South Africa, this income will be considered to be from a South African source if it is found that the dominant cause of the income received relates to the services rendered by the expatriate in South Africa. This type of employment arrangement will, therefore, result in a South African corporate income tax liability for the home country employer (assuming there is no tax treaty relief available).

Where there is a corporate income tax liability in South Africa according to domestic law, it should be considered whether a tax treaty could provide relief. Assuming there is a tax treaty between the home country and South Africa, there is likely to be an exemption for situations where the home country entity does not create a permanent establishment in South Africa. The risk, however, of creating a permanent establishment would need to be carefully monitored, especially where the home country employer sends multiple people to South Africa. Monitoring this business travel can be a challenge, especially where the business does not have a central reporting structure and divisions within the entity do not communicate with each other. Where the home country employer sends employees to South Africa for more than 183 days in a 12-month period, or where these employees negotiate or conclude contracts on behalf of the home country employer while in South Africa, there is a strong possibility of the home country employer creating a permanent establishment in South Africa (resulting in corporate income tax consequences).

#### *5.2.1.2 VAT consequences*

It is possible for this type of arrangement to result in a VAT liability for the home country employer in South Africa where: (i) the activity it is conducting is considered to be carried on continuously or regularly; (ii) the home country employer receives some compensation for supplying this service in South Africa; and (iii) where the compensation received for the supply of goods or services in South Africa amounts to more than R1 million in a 12 month period (or alternatively, the home country employer chooses to register for VAT at the R50,000 optional threshold).

To determine whether the activity is being carried on continuously or regularly, the number of expatriate employees and the duration of their stay in South Africa would need to be considered (PricewaterhouseCoopers Tax Services (Pty) Ltd: 2016c). Where there are regular visits to South Africa (or a single longer secondment) there is a possibility that the activity being conducted in South Africa will be seen as being carried on continuously or regularly. The only test remaining then, is whether there is any compensation for the supply of this service and whether this compensation exceeds the required VAT registration threshold of R1 million.

*5.2.1.3 Employees' tax consequences*

Where the home country remains the legal and economic employer (where there is a non-resident employer) and this entity pays the expatriate's remuneration, there will only be a liability to withhold employees' tax in South Africa where this non-resident employer has a representative employer in South Africa. This will occur when the home country employer has a public officer in South Africa (assuming the employer is a company) or an agent with authority to pay remuneration in South Africa. The home country employer is likely to have public officer in South Africa where it creates a permanent establishment, is seen to be carrying on a business, or is earning income from a South African source (in terms of the dominant impression test).

Where this employment arrangement results in the home country employer being liable for employees' tax in South Africa due to domestic provisions, it should be considered whether tax treaty relief may apply to any income received from employment. If there is a tax treaty between the home country of the employee and South Africa and:

- the duration of the stay does not exceed 183 days;
- the employee's remuneration is not paid by or on behalf of (including recovered from) a South African entity; and
- no permanent establishment is triggered (according to the tax treaty between the employee's home country and South Africa),

it is possible that there would be no employees' tax obligation in South Africa, due to tax treaty relief.

*5.2.1.4 As-is employment conclusion*

This type of employment arrangement may expose the home country employer to a number of tax consequences in South Africa. Depending on the facts relating to this type of employment arrangement, this could include corporate income tax, VAT and employees' tax. This is increasingly significant where assignments are for a longer term or more frequent in nature.

### 5.2.2 Home-based employment

A home-based employment arrangement occurs where the employee retains his or her employment contract with the employer in the home country and retains a connection with this employer. The employee is "seconded" or "loaned" to a host country employer to work for the benefit of the host country employer. The employee's home country employment contract is <u>not</u> suspended (Deloitte Total Reward and Benefits Limited: 2015; PwC: 2014). The likely tax consequences of this type of arrangement in South Africa are as follows:

*5.2.2.1 Corporate income tax consequences*

In this type of employment arrangement, the first question that needs to be considered is whether the home country employer will be earning any income from a South African source relating to the activities that the expatriate is conducting in South Africa. As the home country employment contract is not suspended, there is a possibility that the expatriate employee may be working for the home country employer for at least a portion of time while the expatriate is physically present in South Africa. It may be difficult to prove that the expatriate employee is not performing services for the home country employer, which could result in the home country employer having income from a South African source. The dominant impression test would need to be applied to determine whether the source of any income earned by the home country employer is in South Africa. The onus of proving that income is not subject to South African corporate income tax will rest on the home country employer (section 102 of the Tax Administration Act).

If the home country employer earns income from a South African source, the terms of the tax treaty between the home country and South Africa (if any) should be examined to determine if the home country employer has a permanent establishment in South Africa. Where the expatriate employee is present in South Africa for more than 183 days in a 12-month period or where these employees negotiate or conclude contracts on behalf of the home country employer while in South Africa, there is a strong possibility of the home country employer creating a permanent establishment in South Africa (resulting in corporate income tax consequences).

*5.2.2.2 VAT consequences*

Similar to the "as-is" employment arrangement, the question is likely to be whether the home country employer receives any compensation for the services being performed in South Africa (or for the supply of the expatriate employee to the host country employer). If so, the next questions are whether: (i) the home country employer is conducting an activity continuously or regularly in South Africa; and (ii) whether the home country employer either chooses to voluntarily register for VAT or receives compensation of more than R1 million in a 12-month period for the supply of these services. If all of the above conditions are met, the home country employer will be deemed to have an enterprise in South Africa and will be required to register for and account for VAT in South Africa.

*5.2.2.3 Employees' tax consequences*

If the host country employer pays the expatriate any remuneration (including providing any fringe benefits) it will be required to withhold employees' tax on the remuneration. If the home country employer pays the expatriate any remuneration, the employees' tax liability for the home country employer is the same as described under the "as-is" employment arrangement.

If the home country employer continues paying the expatriate's remuneration and recovers this amount from the host country employer (that is, the costs of the expatriate employee are borne by the South African employer):

- the South African employer will be liable to withhold employees' tax on this remuneration (as it is an employer liable to pay remuneration); and
- tax treaty relief will not be available as the South African employer will be considered to be the economic employer of the expatriate and the remuneration will be determined to have been paid on behalf of the South African employer.

*5.2.2.4 Home-based employment conclusion*

A home-based employment arrangement may result in the home country employer being subject to the following taxes in South Africa: corporate income tax, VAT and employees' tax.

### 5.2.3 Host-based employment

A host-based employment arrangement is very similar to a home-based employment arrangement, except that the employee's employment contract with the home country employer is "suspended" while he or she is on secondment to the host country employer (the employer temporarily becomes the host country employer and the employee works for the benefit of this employer). The likely tax consequences of this type of arrangement in South Africa are as follows:

*5.2.3.1 Corporate income tax consequences*

Similar to the home-based employment arrangement, in a host-based employment arrangement, it should first be considered whether the home country employer will be earning any income from a South African source relating to the activities that the expatriate is conducting in South Africa. As the home country employment contract is suspended, it may be easier to prove that the source of any income earned by the home country employer is not South Africa. The activities being conducted by the employee while in South Africa are to carry on the business of the host country employer (not the home country employer) and therefore any income earned from these activities relates to the host country employer (not the home country employer).

If it is found that the home country employer earns any income from a South African source (taking into account the dominant impression test), it should be determined if there is a tax treaty in place between the home country and South Africa. Where there is a tax treaty in place, the home country employer would only be liable for tax in South Africa where it is found to have a permanent establishment in South Africa. The test for a permanent establishment would need to be applied to the specific circumstances on a case by case basis.

#### *5.2.3.2 VAT consequences*

The VAT consequences in this type of employment arrangement are the same as described under the "home-based" employment arrangement.

#### *5.2.3.3 Employees' tax consequences*

The employees' tax consequences are the same as those described under the "Home-based" employment arrangement.

#### *5.2.3.4 Host-based employment conclusion*

A host-based employment arrangement may result in the home country employer being subject to the following taxes in South Africa: corporate income tax, VAT and employees' tax. From a corporate income tax perspective, however, it may be easier to prove that the employee is not conducting any activities for the home country employer and hence that the home country employer's income would not be income from a South African source.

### 5.2.4 Local hire or transfer

Local hire or transfer occurs where the employee terminates employment with his or her home country employer and instead is employed directly by the host country employer on a "local" contract (PwC: 2014). It is assumed that in this type of employment arrangement, the expatriate employee is carrying on only the business of the host country employer while in South Africa and the home country employer will not have any ties to the expatriate and will not earn any income from the expatriate's activities. The host country employer will pay the expatriate's remuneration. In this case, the host country employer is both the expatriate's legal and economic employer. The likely tax consequences of this type of arrangement in South Africa are as follows:

#### *5.2.4.1 Corporate income tax consequences*

There would be no risk that the home country employer would need to account for or register for corporate income tax in South Africa as this entity is not earning any income from a South African source from the expatriate's activities in South Africa and has no connection to the expatriate. The host country employer will instead account for all associated corporate income tax consequences.

*5.2.4.2 VAT consequences*

There would be no risk that the home country employer would need to account for or register for VAT in South Africa as this entity is not carrying on any activity in South Africa. The host country employer will instead account for all associated VAT consequences.

*5.2.4.3 Employees' tax consequences*

There would be no risk that the home country employer would need to account for or register for employees' tax in South Africa as this entity is not paying and is not liable to pay remuneration to the expatriate employee. It is the host country employer that will be required to withhold the correct employees' tax from the remuneration paid to the expatriate and pay this amount over to SARS.

*5.2.4.4 Local hire or transfer conclusion*

A local hire or transfer employment arrangement appears to be the lowest risk employment arrangement for the home country employer from a South African tax perspective. There are a number of practical disadvantages to this arrangement, however. This type of employment arrangement does not allow the multinational company to provide a guarantee of future employment once the contract with the host country employer expires, nor does it allow the expatriate to remain on the home country pension or medical aid fund while on secondment. Further, this type of arrangement does not cater for a flexible workforce as each time the employee changes employment countries, a new employment contract would need to be negotiated between the employee and the host country employer. Therefore, this type of arrangement is not conducive to short term secondments or for employees expected to travel between multiple jurisdictions as part of their roles and responsibilities. This type of arrangement is only likely to work where the expatriate is likely to be based in one jurisdiction for a fairly long period of time.

### 5.2.5 Dual employment

A dual employment arrangement occurs where employees are employed by both the home and the host country employers simultaneously under separate employment contracts, each of which has different terms and conditions (PwC: 2014). The likely tax consequences of this type of arrangement in South Africa are as follows:

*5.2.5.1 Tax consequences*

The tax consequences of the contract with the home country employer and the host country employer each need to be considered separately to determine the overall consequences for the multinational group. The tax consequences of the employment contract between the expatriate and the home country employer are as follows:

- If the expatriate employee only works for the host country employer while physically present in South Africa, the tax consequences of this arrangement for the home country employer will be the same as the "local hire or transfer" employment arrangement described above. That is, the home country employer will not have any corporate income tax, VAT and employees' tax consequences in South Africa.
- If the expatriate works for the home country employer for a portion of time while he or she is physically present in South Africa, however, the corporate income tax consequences will be the same as described above under the "as-is" employment arrangement.

The tax consequences of the employment contract between the expatriate and the host country employer are that the host country employer will only account for tax in South Africa on the contract that relates to its arrangement with the expatriate employee (and not the arrangement with the home country employer).

*5.2.5.2 Dual employment conclusion*

The tax benefits of a dual employment arrangement may only be realised where the expatriate employee has two distinct roles and responsibilities for two distinct employers and will perform <u>only</u> the roles and responsibilities relating to the host country employer while in South Africa. Where this separation between roles cannot be maintained, there is a possibility that the home country employer would become liable for the following taxes in South Africa: corporate income tax, VAT and employees' tax.

### 5.2.6 Global employment companies

A global employment company essentially acts as an international labour broker for a multinational group of companies. Expatriates are employed by the global employment company (their legal employer) and are then "loaned" or "assigned" or "seconded" to a host country employer (in this case, a South African company). This host country employer becomes the economic employer of the expatriate for the duration of the assignment. The expatriate is normally paid all compensation and benefits by the global employment company, which would then re-charge these costs to the host country employer. The global employment company is also likely to charge a service fee for the back-office management that it performs. For purposes of this thesis, it is assumed that the global employment company is not South African tax resident. The likely tax consequences of this type of arrangement in South Africa are as follows:

#### *5.2.6.1 Corporate income tax consequences*

In an employment arrangement where the employer is a global employment company, both the legal employer of the expatriate (the global employment company) and the economic employer may receive income from this arrangement. The legal employer is likely to receive income from the economic employer for making the services of the expatriate available (a re-charge of costs and a service fee as outlined above). The economic employer may earn income as a result of the expatriate's activities in South Africa. The following paragraphs outline whether the income earned by each of these companies is likely to be taxed in South Africa.

*(i) Global employment company*

As the global employment company is not tax resident in South Africa, only income from a South African source would be subject to corporate income tax in South Africa (in terms of the definition of "gross income" in section 1 of the Act). To determine the source of income, the originating cause of the income and the location of that originating cause should be understood (in terms of the test established in the *Lever Brothers and Unilever Ltd* case). The income of the global employment company is likely to be a fee for the service of providing a resource (the expatriate) to the economic employer and a recovery of the costs incurred. It can be argued that the originating cause of this income (the work that the global employment company did to earn this income) is from providing the resource and not due to the work being performed by that resource. The work of providing the resource (such as recruiting the expatriate, entering into the employment contract with the expatriate, paying the expatriate and other back office services) is normally performed by the global employment company in the jurisdiction where it is resident. Therefore, it may be argued that the global employment company is not earning any income from a South African source by providing a resource to work in South Africa. Consequently, this income should not fall within the definition of "gross income" in South Africa (section 1 of the Act) and should not be taxable in South Africa.

Where the above argument is not accepted, and it is found that the dominant cause of the income is South African, the income would be from a South African source and subject to corporate income tax in South Africa, subject to possible tax treaty relief. Considering that:

- the expatriate is not carrying on the business of the global employment company in South Africa, but is carrying on the business of his or her economic employer (article 15(1) of the OECD Model Tax Convention);
- the expatriate is unlikely to be regularly negotiating or signing contracts on behalf of the global employment company (article 15(5)); and
- the business of the global employment company is that of a labour broker and it is unlikely to enter into a construction or installation project (article 15(3)),

it appears unlikely that the global employment company would create a permanent establishment in South Africa due to the activities of the expatriate in South Africa. Therefore, there should be no corporate income tax consequence for the global employment company in South Africa as, firstly, the income is unlikely to be from a South African source, and even if it is, the tax treaty (if one is in place) should be able to provide relief.

*(ii) Economic employer*

In this case, the host country employer (a South African tax resident) would be the economic employer. To the extent that the company earns income as a result of that expatriate's services in South Africa, this income would be subject to corporate income tax in South Africa.

*5.2.6.2 VAT consequences*

To understand the VAT consequences where there is an inbound expatriate, which entities will receive compensation relating to the expatriate in South Africa needs to be determined. As is the case with corporate income tax, this could be either or both the global employment company (the legal employer) and the economic employer of the expatriate. This is because the legal employer may receive compensation from the economic employer for the supply of a resource. The economic employer, in turn, may receive compensation from its customers relating to the services carried out by the expatriate in South Africa.

*(i) Global employment company*

The global employment company, acting as an international labour broker, is paid compensation for supplying a resource (the expatriate) to the economic employer. As this expatriate is sent to South Africa, the global employment company is receiving compensation for the supply of services in South Africa. To determine whether this supply of services will result in a VAT liability in South Africa, it needs to be determined whether: (i) the global employment company is conducting an activity continuously or regularly in South Africa; and (ii) whether the compensation for this supply of services amounts to more than R1 million in a 12-month period. If the above two conditions are met, the global employment company will be deemed to have an enterprise in South Africa and will be required to register and account for VAT in South Africa.

*(ii) Economic employer*

The economic employer, being a South African company, will account for all associated VAT consequences on the sale of services to a customer (where relevant).

*5.2.6.3 Employees' tax consequences*

A non-resident employer (the global employment company) pays the expatriate's remuneration. This non-resident employer recovers these costs (by way of a re-charge) from the host country employer, however. Therefore, it can be said that the host country employer in South Africa is effectively liable to pay the remuneration and will be considered to be the employer of the expatriate for the purposes of the Fourth Schedule to the Act. In effect, the re-charge of costs to the host country employer ensures that the cost of the expatriate employee aligns with the entity receiving the benefit of the employee, which can then claim the corporate tax deduction (being an expense incurred in the production of its income in terms of section 11(a) of the Act).

The global employment company will not be liable for employees' tax in South Africa, but, according to domestic law, the host country employer is the entity liable to withhold employees' tax in South Africa on the remuneration from a South African source that it is liable to pay to the expatriate (including the remuneration re-charged by the global employment company).

Tax treaty relief for this employees' tax will not be available as the economic employer of the expatriate is a South African entity. This means that the employee's remuneration is effectively paid on behalf of the South African entity by the global employment company (because it is recovered from the South African entity by the global employment company).

*5.2.6.4 Global employment company conclusion*

In the case of a global employment company, this type of employment arrangement is typically used where there is a need within a multinational group of companies to have a pool of talent that can be deployed easily to various countries to assist with specific needs within an organisation. This company effectively acts as an international labour broker for its group of companies. Both the global employment company and the economic employer (the host country for the period the expatriate is on secondment) are likely to earn income from this arrangement.

The global employment company should not be subject to corporate income tax in South Africa. It will, however, be liable to account for VAT if the service of providing expatriates to the South African entity is continuous or regular in nature and if the compensation it receives for this is more than R1 million within a 12-month period. From an employees' tax withholding perspective, the global employment company should not be liable for this, as this liability is likely to lie with the South African host country employer.

The host country employer (the South African entity) will be liable for corporate tax and VAT and liable to withhold employees' tax.

The economic employer, normally the South African host country employer, may in certain situations be a foreign company. In this case, this foreign economic employer may have a corporate income tax exposure in South Africa if it is earning any income from the expatriate's activities in South Africa and the tax treaty does not provide tax relief. This foreign company may also be subject to VAT and employees' tax. This situation can be equated to the "As-Is" model described above.

### 5.3 THE TAX ADVANTAGES OF USING A GLOBAL EMPLOYMENT COMPANY AND COMPARISON OF DIFFERENT EMPLOYMENT ARRANGEMENTS

From the above discussion, it can be seen that each type of employment arrangement tends to cater for a specific set of facts:

- An "as-Is" arrangement is used in instances where the expatriate reports to the home country employer and there may not be a company that is part of the multinational group in the host location. This type of arrangement may expose the home country employer to numerous tax consequences in South Africa.
- A "home-based" arrangement allows the expatriate to provide services to both the home and host employer, but again, this can create a number of tax consequences for the home country employer in South Africa.
- A "host-based" employment arrangement, although similar to the home-based arrangement, is effectively used where the expatriate's economic employer is the host country employer and the employee does not provide any services to the home country employer. This arrangement may shelter the home country employer from certain corporate income tax consequences, if set up correctly.
- A "local hire or transfer" is likely to provide the most protection from South African tax consequences for the home country employer, as the expatriate has no connection to the home country employer and only provides services to the host country employer. This type of

arrangement does not allow for the flexibility of deploying expatriates quickly, as a new employment arrangement has to be negotiated each time an expatriate moves to a different jurisdiction.

- A "dual" employment arrangement caters for the situation where an expatriate has two distinct and separate roles in two different entities within a multinational group of companies and this type of arrangement may provide protection from tax consequences if set up correctly and the expatriate is not providing any services to the home country employer while in South Africa.

A global employment company will not prevent a home country employer (a foreign company) from being subject to tax in South Africa where the expatriate renders services to that home country employer while in South Africa and this entity earns income as a result of the services performed. In this instance, the home country employer is still likely to be subject to a number of tax consequences in South Africa (similar to the "as-Is" model). Therefore, this type of employment arrangement will not limit or mitigate the tax consequences in South Africa where a foreign company is the economic employer of the expatriate.

A global employment company is, however, useful in simplifying and possibly limiting the tax consequences where there are multiple expatriates and each expatriate's economic employer will be the host country employer (in this case South Africa), but their legal employers are different offshore companies. It is important that the expatriates are not performing any services for their offshore legal employers.

In this instance, a global employment company may be used in place of a home-based or host-based approach to limit the tax consequences to one offshore entity, rather than having the possibility of multiple offshore entities needing to consider tax consequences in South Africa. Consider the example where a South African company obtains the services of three different expatriates from three different home country locations. Each of these home country employers would need to consider the possible tax impact of sending an expatriate to South Africa. If all three expatriates are employed by a global employment company, however, only this company needs to consider the South African tax consequences of seconding individuals to South Africa. In this way, the tax impact for a multinational group of companies may be simplified and limited.

Using a global employment company allows for flexibility in deploying employees quickly across borders, as the main employment arrangement remains in place and does not need to change each time an expatriate is employed in a new jurisdiction. If flexibility is not required when deploying expatriates, a local hire or transfer may provide greater tax certainty in that there should be no exposure for an offshore company in this instance. This assumes that the expatriate is only working for the host country employer.

Therefore, using a global employment company is only likely to have a positive impact for a multinational group of companies from a tax perspective where:

- the expatriate's economic employer is the host country employer (for example, a South African entity for the duration of the secondment to South Africa);
- flexibility is required to easily deploy this expatriate to other jurisdictions; and
- the multinational group has a number of expatriates that fulfil these two requirements.

Wherever the legal employer of the expatriate is an offshore company, this company would need to consider whether it is exposed to potential tax consequences in South Africa. Having only one legal employer (the global employment company), would mean that the potential tax consequences in South Africa are limited to this company and its income. This prevents tax authorities in South Africa from claiming that the income of other foreign companies within the multinational group may be from a South African source and therefore taxable in South Africa (if a foreign company is not the economic employer of the expatriate). This is especially useful where tax authorities are aggressive in their interpretation of the source of income and of tax treaty relief. This means that a global employment company effectively limits any cross-border tax consequences to itself, centralising any tax obligations and preventing exposure for the rest of the group.

## 5.4 SUBSTANCE OF THE EMPLOYMENT CONTRACT VERSUS THE FORM OF THE EMPLOYMENT CONTRACT

When determining the tax consequences of the employment arrangement, the importance of understanding the substance and form of the employment arrangement and how this is interpreted in South African law is relevant. Recent court decisions in South Africa indicate that the substance (true essence or intention) of the transaction should take precedence over the legal form of the transaction or the contract (De Koker & Williams: 2017b; Stiglingh *et al*: 2017). The decision in Duke of Westminster v IRC, 51 TLR 467, 19 TC 490 indicates that nothing prevents a taxpayer from arranging his or her or its affairs in a tax optimal manner. In this case, however, the court indicated that entering into a sham transaction, where a taxpayer disguises a transaction to make it appear as something else, is not acceptable (De Koker & Williams: 2017b; Stiglingh *et al*: 2017).

Stiglingh *et al* (2017: online) summarise as follows:

> *The principle of 'substance over form' therefore confirms the practice that the true intention behind a transaction is of utmost importance, irrespective of what is recorded in the resulting contracts. However, the principle only applies where the parties to it do not really intend it to have, inter partes, the legal effect which its terms convey to the outside world...*
>
> *the principle of 'substance over form' has its limitations and cannot simply be used to ignore agreements where the parties in fact and in law intend to give effect to an agreement...*

Therefore, when examining employment arrangements, the actual intention of the parties needs to be ascertained. To ensure that tax authorities do not query the arrangement, it is preferable that the legal form of the employment arrangement is recorded accurately to support the substance and intention of the arrangement.

A global employment company would only in reality provide protection from tax for the multinational group of companies where the intention is that the expatriate's economic employer is the South African entity (the host country employer) and not where the intention is that the expatriate is actually providing services to an offshore entity. Where a foreign company (other than the global employment company) is the economic employer of the expatriate and earns income due to that expatriate's activities in South Africa, South African courts may look through the form of the contract with the global employment company to determine the entity to which the expatriate is actually providing services.

## 5.5 CONCLUSION

This chapter outlined the South African tax impact likely to apply according to the employment arrangement in place and which entity within the multinational group is likely to be impacted by the South African tax requirements. It then analysed whether a global employment company may mitigate any of the South African tax risks for the foreign company.

It was found that using a global employment company could limit or simplify some of the tax exposure for a foreign company sending an expatriate to South Africa, but only in very specific circumstances. A global employment company will only limit or simplify the tax consequences for the multinational company where the entity that is the economic employer of the expatriate is the South African company, while the legal employer of the expatriate is a foreign company. This simplification would only likely be realised where there are multiple expatriates sent to South Africa, originating from different offshore companies and the economic employer of all these expatriates is the South African entity. In this case, using a global employment company as the legal employer, would limit the number of potential home-host country combinations, allowing the multinational company to better control its tax exposure while enabling the expatriate workforce to be flexible and mobile without entering into a new employment agreement for each jurisdiction.

This type of employment arrangement may therefore be appropriate where the multinational company requires a pool of talent to be mobile and available to assist in various host country locations, as the need arises. It may also be appropriate if the host country (South Africa) wished to employ talent from multiple locations. This can provide a benefit where the multinational company requires an "internal labour broking service" to manage its pool of employee talent. An example of where this may be appropriate is in the engineering field, where experts are called on by host country employers to assist with specific projects and then are sent to the next jurisdiction to assist with the next project.

The substance of the transaction over its legal form will be considered in South Africa, if the parties did not intend to give effect to the legal form of the contract. If for instance, the foreign employer is the economic employer of the expatriate, the South African tax authorities may look through the contract with the global employment company and tax the transaction according to its substance. This could result in a tax liability for the foreign economic employer in South Africa.

The next chapter presents an overall summary of the findings of the research and provides some ideas of further research that may be performed relating to this topic.

# CHAPTER 6: CONCLUSION

## 6.1 INTRODUCTION

The primary goal of this thesis was to understand whether using a global employment company could mitigate the South African tax risks for multinational companies when sending inbound expatriates to South Africa. To achieve this, a number of sub-goals were proposed:

(i) to describe the different employment arrangements that multinational companies use when sending their employees cross-border and the different categories of expatriate employees;
(ii) to analyse the South African tax impact that inbound expatriate employees may create for foreign companies within a multinational group;
(iii) to understand how the South African tax impact relates to the employment arrangement in place and which entity within the multinational group is likely to be impacted by the South African tax requirements, depending on the employment arrangement; and
(iv) to determine whether using a global employment company as the employer of inbound expatriates into South Africa will in any way simplify or limit the adverse tax consequences for the multinational company in South Africa, compared to the other possible employment arrangements.

An interpretative research approach was applied, with inductive reasoning to explore these goals. This chapter outlines how these goals were achieved and provides a summary of the findings of this research.

## 6.2 SUMMARY OF FINDINGS

### *(i) First research sub-goal: describe expatriates and employment arrangements*

To achieve the goal of describing the different employment arrangements that multinational companies use when sending their employees cross-border and the different categories of expatriate employees, a literature review was performed. The results of this review were presented in Chapter 2. It was found that the definition of an expatriate, which applies in the context of this research, is an employee sent by his or her employer to live and work in another country, and the definition of the expatriate employee's "home country" should be the expatriate's country of original employment (Financial

Times: Unknown; Waggoner & Punnett: 2017). An expatriate could therefore include employees relocated in terms of formal secondments and informally mobile employees, such as short-term business travellers.

Typical employment arrangements used by multinational companies to employ their globally mobile employees were found to include the following: as-is employment, home-based employment, host-based employment, local hire or transfer, dual employment and a global employment company. Chapter 2 provided a description of each of these employment arrangements, including which entity was the legal employer or the economic employer and which entity was likely to pay remuneration to the expatriate.

In investigating the different employment arrangements, the distinction between a legal employer and economic employer was found to be a key consideration. The legal employer was determined to be the employee's common law employer (the entity that holds the primary employment contract with the employee and the entity that the employee would approach to terminate their contract of employment). The economic employer was found to be the entity that receives the economic benefit of the employee (the entity which bears the key risk and responsibility for the employment).

*(ii) Second research sub-goal: analysing the South African tax impact created by inbound expatriates*

To achieve the goal of determining the South African tax impact for a foreign company that sends an expatriate to South Africa, the relevant South African tax legislation was systematically analysed to determine its applicability to a situation where an inbound expatriate is sent to South Africa. South African tax legislation, the OECD Tax Model Convention and various other sources were analysed to determine the possible tax exposure, including corporate income tax, VAT and employees' tax. The findings in relation to this goal were set out in Chapters 3 and 4 of this thesis as follows:

In chapter 3 it was established that a foreign company is only taxable in South Africa on its income from a South African source (unless tax treaty relief applies). In the case of expatriates, the source will generally be determined according to where the services are physically performed.

In general, where a tax treaty applies, a foreign company will be subject to corporate income tax in South Africa only where this foreign company has a permanent establishment in South Africa. The findings indicated that a permanent establishment occurs where:

a) there is a fixed place of business through which the expatriate carries on the business of an enterprise (article 15(1) of the OECD Model Tax Convention); or
b) a building, construction or installation project is carried out for a certain period, normally 12 months (article 15(3)); or
c) where the expatriate habitually exercises the authority to conclude contracts in the name of the enterprise (article 15(5)).

Chapter 4 continued the analysis of the tax consequences by establishing when VAT and employees' tax would be applicable. It was found that a foreign company will have a VAT liability only where this company carries on an enterprise or activity continuously or regularly in South Africa which involves the supply of goods or services and for which a consideration is paid. The VAT registration threshold also needs to be met (where taxable supplies exceed R1 million in a 12-month period). It was found that the act of providing expatriates to an entity in South Africa could be considered to be the supply of a service.

Determining whether an expatriate will create a VAT liability and registration requirement for a foreign company was found to involve (i) whether the supply is continuous or regular; and (ii) whether the consideration received by the foreign company meets the VAT registration threshold.

In relation to employees' tax, it was found that a foreign employer will be liable to withhold employees' tax in South Africa only where it has a representative employer in South Africa. This could occur in two instances: (i) in the case of a company, where there is a public officer; or (ii) in the case of a non-resident employer, where there is an agent with authority to pay remuneration. A public officer must be registered by a company when it is carrying on a business in South Africa or has an office in South Africa. Effectively, a foreign company is required to maintain an office in South Africa when it registers as an external company (branch) in South Africa, is found to have a permanent establishment in South Africa, and technically where it earns any income from a South African source (even where tax treaty relief applies). An agent with authority to pay remuneration occurs where there is a person in South Africa who acts on the authority of the foreign company and this person has authority to pay any remuneration to the employee, whether in terms of an express or implied agreement.

It was found that where a foreign company charges a local South African company an amount, it should be carefully considered whether this is for the provision of services or for the provision of a person to perform services. This distinction is important in determining whether the foreign company or the South African company is, in effect, the employer of the expatriate for employees' tax withholding purposes. In the first instance, the foreign company will remain the employer of the expatriate and there will only be an employees' tax withholding obligation in South Africa if the foreign company has a representative employer in South Africa. But in the second case, there is an argument that the expatriate is actually the employee of the South African entity (as the South African entity is effectively liable to pay remuneration to the employee) and hence employees' tax should be withheld by the South African entity.

If there is a tax treaty between South Africa and the country where the expatriate is tax resident, relief from employees' tax withholding would only be available in South Africa where all of the following conditions are met:

- the expatriate is not in South Africa for more than 183 days in a 12-month period;
- the expatriate's remuneration is paid by or on behalf of a non-resident employer (that is, the expatriate's economic employer must not be a South African entity); and
- the remuneration is not borne by a permanent establishment of that employer in South Africa.

Chapter 5 sought to provide an understanding of the application of the various tax principles in South Africa to the different employment arrangements. It further considered which entities are likely to be impacted. The following conclusions were reached:

| | |
|---|---|
| As-is employment: | There is a strong possibility that the home country employer may be subject to a number of tax consequences in South Africa, especially where this foreign company has expatriates in South Africa for more than 183 days in a 12-month period. |
| Home-based employment: | There is a possibility that the home country employer may be exposed to a number of tax consequences in South Africa. This will largely depend on whether this company earns any income due to the activities of the expatriate in South Africa as well as how long its expatriates are in South Africa. |

| | |
|---|---|
| Host-based employment: | Similar to the home-based employment arrangement, but if the employee's economic employer is the host country employer the home country employer may not earn income due to the expatriate's activities in South Africa. |
| Local hire or transfer: | There should be no tax liability in South Africa for a foreign company under this arrangement. |
| Dual employment: | If set up correctly and it can be proved that the expatriate does not perform services for the home country employer while in South Africa, there should be no tax liability in South Africa for the home country employer under this arrangement. |
| Global employment company: | There is an argument that the global employment company should not have a corporate income tax liability in South Africa, but it is likely to have a VAT liability. The global employment company should not be required to withhold employees' tax, as this liability is likely to fall on the host country employer (due to the recharge of employee costs). |

Applying the findings in Chapter 5, it was concluded that a global employment company may provide a tax benefit in South Africa only in very specific circumstances:

- where the economic employer of the expatriate is the South African entity;
- where flexibility is required to easily move the expatriate to other jurisdictions, as a local hire or transfer arrangement will provide fewer tax obligations for the foreign company in South Africa, but this arrangement does not cater for the flexibility needed to move employees;
- where there are multiple home-host country combinations that the multinational group needs to consider when moving its expatriates.

## 6.3 LIMITATIONS AND ASSUMPTIONS

In this thesis, the following limitations and assumptions applied:

- the home country employer is a foreign company that is not tax resident in South Africa, whereas the host country employer is a South African company;
- the global employment company is not tax resident in South Africa;

- the services rendered by the inbound expatriates will fall within the general source principles applying in South Africa and tests established in case law;
- the income earned by the foreign corporate entity from the expatriate's activities in South Africa will fall under the business profits article of the tax treaty and will not be considered a royalty or other type of income stream;
- only income from employment (article 15 of the OECD Tax Model Convention) has been considered when determining the tax treaty application of employees' tax and not the more specific income streams, such as directors' fees or pensions;
- independent contractors have not been considered and it is assumed that there is an employment relationship in place with the expatriate employee;
- expatriates do not work on an aircraft or aboard a ship or boat in South Africa;
- as contributions to the Unemployment Insurance Fund and the Skills Development Levy are not collected by SARS for inclusion in the national revenue fund, the impact of these payments has not been included in this thesis;
- unless otherwise stated, reference to the OECD Model Tax Convention and the OECD Commentary refer to the 2014 version.

## 6.4 OPPORTUNITIES FOR FURTHER RESEARCH

The tax consequences of the cross-border movement of employees are complex and companies need to carefully consider the exposure that they open themselves up to when sending their employees to work in a jurisdiction other than the jurisdiction in which they are tax resident. Some of the ideas gained for further research into the cross-border movement of employees and the employment arrangements that may be used to employ them are, *inter alia*, as follows:

- Where a company uses a global employment company to employ their expatriates, research could be done into what factors should be considered when determining the jurisdiction in which the global employment company should be located.
- Even if tax is not a primary reason for having a global employment company, there may be other advantages to having a central management function for expatriates. Further research could be done on what advantages central management of expatriates may have for a multinational group.
- In determining whether a global employment company should be used, the cost of setting up and maintaining this company will be a factor. A case study could be performed to understand the

costs involved in setting up and maintaining this type of company in various jurisdictions. The approximate expatriate population size that would make this type of employment arrangement viable could then be explored.

- Due to technology and the increasing connectivity of society, companies will question the need to physically relocate employees to carry out the work. When does the employee need to be in that jurisdiction and do they need to be there all the time? (PwC: 2012). The interaction of how technology is changing work patterns of employees and how this may influence a multinational group's overall tax burden in future could be explored. What tax planning opportunities do the use of technology and the ability to have a variable workplace provide for a multinational group?
- Global mobility is likely to become a strategic tool for companies in future (PwC: 2012; Deloitte LLP: 2015). Determining the factors that make for a successful secondment and how to align the global mobility programme of a multinational group of companies to the strategy of this group could be explored.

## 6.5 FINAL CONCLUSION

It was found that using a global employment company may mitigate the South African tax risks for a multinational company with inbound expatriates only in very limited circumstances. This is because the global employment company can be used to reduce the number of legislative combinations that a multinational company needs to consider when moving its expatriate population to different host countries, but only if the economic employer of the expatriate is the host country employer (in this case, a South African tax resident). In effect, a global employment company is likely to provide tax benefits only where it acts as an international labour broker for the multinational company of which it is a part.

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**LEGISLATION**

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